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Building A Better America: Tax Expenditure Reform and the Case of State and Local Government Bonds and Build America Bonds

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Abstract
Currently most subnational government borrowing in the United States is done via tax-exempt muni bonds. But they are riddled with problems. They are inefficient at delivering the subsidy, and they create economic distortions of investment choices. They are inequitable, and they have significant democratic deficiencies. Direct payment Build America Bonds (BABs) provide an alternative, as they directly pay a cash subsidy to a subnational government. While there are simple technical problems that can easily be remedied, BABs face significant political hurdles that will prevent the permanence of the program. Policy entrepreneurship is a way forward. The piece also discusses how the type of analysis used here can also be used on other tax expenditure matters.

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I. Introduction

In 2010, the National Commission on Fiscal Responsibility and Reform (aka the Bowles-Simpson Commission) filed its report on balancing the federal budget. One of the key parts of the proposal focused on raising revenues by broadening the base through closing so-called tax loopholes for individuals and corporations.¹ These special loopholes and considerations are called tax expenditures.

Yet, for something so vital, our national discussions on tax expenditures remain rather thin. Since its introduction by Stanley Surrey and later further developed by Surrey and Paul

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McDaniel in their classic work, our discussions often remained paralyzed by an inability or lack of desire to explore any tax expenditure in detail. Instead we tend to generalize broadly about all tax expenditures. This paper seeks to join a growing chorus of tax analysts who are calling for a deeper exploration of tax expenditures and a shift in tax policy.

In particular this paper seeks to do this by examining one particular tax expenditure in detail, the tax exemption of interest payments on state and local government bonds. These are bonds issued by states and local government entities to fund capital projects. It is a large tax expenditure, and many have even called for its elimination for both its revenue raising potential and economic reasons. That said, there are some countervailing arguments as to why we do want to maintain this tax expenditure, mainly that it keeps borrowing costs, and thus the tax rates of state and local governmental entities, which this paper sometimes refer to as subnational governments, lower.

This paper will not look to see if the subsidizing subnational governments’ borrowing is justified. Such an exploration is an empirical matter that this paper will bracket for future exploration. The paper assumes that the goal of the national government aiding subnational units is justified. Such an assumption though is likely not far off, because the major source of financing, decision-making, and management of infrastructure matters, like roads, bridges, ports, which are all essential to people’s lives as well as for the overall economy, in the U.S. comes at the subnational level, and not directly from the federal government. The elimination of such

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3 BOWLES-SIMPSON supra note 1 at 21.
borrowing would likely hinder the effective development of infrastructure.\(^5\) The hope is that the analysis and framework could also be used in other cases.

But even if entirely justified, tax-exempt munis, the name that the finance sector has for state and local bonds, do not effectively meet the stated goal of having the federal government subsidize subnational borrowing. This paper seeks to focus in on the various problems munis face in effectively implementing their justified policy goal.

As explained in later sections this analysis will illustrate how tax-exempt munis are highly inefficient at two levels. First, there is revenue inefficiency. The amount of the subsidy is far lower than the forgone revenue. Some state that the subsidy’s value is only $0.80 going to the state of every $1 of forgone tax revenue.\(^6\) The second is economic inefficiency. This inefficiency too has two flavors, first it is economically problematic, because it leads towards portfolio distortion Second, which is a direct effect from the first, and there is a limited base of creditors.

Tax-exempt munis also suffer from a major equity problem. The tax benefit mainly accrues to high-income individuals, and it is unlikely that the benefits necessarily help lower income individuals. This raises serious distributive justice concerns.

Tax-exempt munis also suffer from a lack of transparency. The hidden nature of the subsidies that tax-exempt munis create erodes democratic buy-in and effective participation. It warps our ability to discuss such a vital matter of taxing and spending well.

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\(^5\) See Congressional Budget Office and Joint Committee on Taxation, Pub. No. 4005, Subsidizing Infrastructure with Tax-Preferred Bonds 18, 25-28 (2009) (stating that tax-exempt bonds account for $1.7 trillion in financing to subsidize infrastructure projects, and of that $1.3 trillion are tax-exempt bonds issued by subnational governments during the period between 1991-2007, and outlining the methodology to reach these numbers and measure the importance of tax-exempt munis) hereinafter CBO-JCT.

\(^6\) Id. at 34
That said, a viable alternative does exist. These are the direct-pay tax-credit bonds, also known as Build America Bonds (BABs). BABs are a new type of muni, issued again by subnational governments much like the current tax-exempt munis that exist today. BABs’ main purpose as well, like tax-exempt munis, is to help subnational governments finance capital projects. BABs, differ from tax-exempt munis in two major ways. First, their interest is taxable.\(^7\) Second, as a result, the issuer, i.e. the subnational government unit, gets a subsidy from the federal government at a certain rate.\(^8\) Many subnational governments have enthusiastically issued BABs, during their short life, for infrastructure and other capital projects. BABs solve almost every one of the problems that arise from the use of tax-exempt munis, and thus better reaches the goal of having the federal government subsidize subnational borrowing. But, beyond these improvements, most of the changes BABs make to the existing structure of the I.R.C. are minimal. And BABs have the final advantage of actually selling well, unlike other alternatives to the current set of tax-exempt munis.

Yet, BABs have their problems. Many are technical, and can easily be fixed through regulations or legislation. But, a deeper problem is the politics that surround BABs. These may not only block BABs replacing tax-exempt bonds, but may even kill the small pilot BAB program that is in existence currently. This paper seeks to unravel these means in the hopes that enterprising policy advocates will be cognizant of these problems.

The paper is structured as follows: the next section provides a general explanation of tax expenditure analysis and its link to tax and budget policy. Tax expenditure analysis was originally developed merely to show the equivalence between a specialized tax break and a direct expenditure of funds. The section also examines how many people have taken tax expenditure

\(^7\) I.R.C. § 54AA(f)(1)  
\(^8\) I.R.C. § 54AA(g)
analysis to problematic extremes, either denying its validity of equivalence or claiming that
every tax expenditure is wrong. Those who taint every tax-expenditure as a normative evil
include many of the budget hawks like the Bowles-Simpson Commission. Those committing the
fundamental error about the equivalence to direct spending include individuals like Grover
Norquist and the Supreme Court in its recent *Arizona Christian Schools v. Winn* decision.
Readers already familiar with tax expenditures and the problematic policy debates surrounding
them may want to quickly skim the section.

Section III examines how tax-exempt munis are a problematic tool to meet their justified
goal of effectively allowing states and localities to borrow at lower rates. It outlines the history,
economic efficiency concerns, equity concerns, administratbility concerns, and democratic
problems with this tax expenditure. It also begins to show why full repeal may not be a good idea
either.

Section IV explains and outlines the advantages of BABs. It looks toward the third
question of alternative means of achieving the policy goals of subsidizing state and local
governments.

Section V shows some of the small problems with BABs. They are important, but easy to
overcome with tweaking of the system. The two issues examined in detail are the bond
origination fee issue and offset.

Section VI highlights the major political obstacles to BABs. It draws on some political
science work as well as other political analysis that shows BABs face serious hurdles. Only
entrepreneurial leadership in Congress and probably major fundamental tax reform are likely to
solve these problems.

Section VII concludes the paper.
II. Tax Expenditures and Tax Policy

While they have been around since the 1970s, many policy makers and the general public still do not have a firm grasp on the concept of tax expenditures. Below is an explanation of those tax expenditures followed by situations where our misunderstanding of tax expenditures lead us astray in our national debate.

A. The Basic Concept

Tax expenditures have been part of federal budget discussions since the passage of the Congressional Budget and Impoundment Control Act of 1974. The law codified the ideas originally put forward by Stanley Surrey, which he later expounded further on in his seminal work with Paul McDaniel Tax Expenditures.

In their work, Surrey and McDaniel reach to the core as to what is a tax expenditure and what is tax expenditure analysis. Few can do better than their explanation. They write:

The tax expenditure concept posits that an income tax is composed of two distinct elements. The first element consists of structural provisions necessary to implement a normal income tax, such as the definition of net income, the specification of accounting rules, the determination of the entities subject to tax, the determination of the rate schedule and exemption levels, and the application of the tax to international transactions. These provisions compose the revenue-raising aspects of the tax. The second element consists of the special preferences found in every income tax. These provisions, often called tax incentives or tax subsidies, are departures from the normal tax structure and are designed to favor a particular industry, activity, or class of persons. They take many forms, such as permanent exclusions from income, deductions, deferrals of tax liabilities, credits against tax, or special rates. Whatever their form, these departures from the normative tax structure represent government spending for favored activities or

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10 SURREY & MCDANIEL supra note 2.
groups, effected through the tax system rather than through direct grants, loans, or other forms of government assistance.\textsuperscript{11}

Thus any tax expenditure analysis must begin with the definition as to what is the proper tax base. For an income tax, that is generally assumed to be the Haig-Simons base.\textsuperscript{12} That means certain deductions, for example one for ordinary and necessary business expenses under I.R.C. § 162, do not count as tax expenditures, but help to determine the base. As Surrey and McDaniel point out too, the Haig-Simons definition does not define rates or accounting rules, and thus too, some of the classic methods of avoiding taxes by adjusting the timing of realization of income, do not count as tax expenditures either.

The key here is that tax expenditures deviate from these normal taxes, and are similar economically to direct government expenditures. Tax expenditures are not an automatically pejorative term though. As Surrey and McDaniel write, “The classification of an item as a tax expenditure does not in itself make that item either a desirable or undesirable provision; nor does it indicate whether the inclusion of the item in the tax system is good or bad fiscal policy.”\textsuperscript{13} Instead they point out that determining whether a tax expenditure is good or bad requires a slightly more nuanced analysis of the underlying policy.\textsuperscript{14} The key strength of tax expenditure analysis for policy making, is by equating a tax expenditure to a direct expenditure, classic tax expenditure analysis helps us focus more closely on the choice of policy lever between administering benefits through the tax system or through direct expenditures.

\begin{flushright}
\textsuperscript{11} \textit{Id.} at 3.
\textsuperscript{12} \textit{Id.} at 4. A Haig-Simons base is an income tax base that is defined as one’s potential annual consumption plus any increases in the stock of wealth over that year. \textsc{Michael J. Graetz} & \textsc{Deborah H. Schenk}, \textit{Federal Income Taxation: Principles and Policies} 96-97 (6th ed. 2009); \textsc{Jonathan Gruber}, \textit{Public Finance and Public Policy} 536 (3d ed. 2011).
\textsuperscript{13} \textsc{Surrey} & \textsc{McDaniel} at 5.
\textsuperscript{14} \textit{Id.} at 6.
\end{flushright}
Unfortunately, our national rhetoric on politics ignores Surrey and McDaniel’s view that tax expenditure analysis is not a value-based judgment. For example, whether it is good policy, both fiscally and more generally, to offer welfare benefits through the tax system via the earned income tax credit (EITC) or whether it makes sense to subsidize home purchases through the home mortgage interest deduction (HMID) require value judgments that merely identifying them as tax expenditures does not yield. Others in our national debate also ignore the basic equivalence that Surrey and McDaniel posit with direct expenditures, and fail to ask the actual relevant policy questions as to whether or not we should subsidize such behavior and whether the tax system or direct spending is a better means to reach that goal. The complexity and confusion of tax expenditures as a concept lead to their abuse.

B. Problems with our Tax Expenditure Discussion

The problem in discussing tax expenditures comes from rather extreme views taken on the issue. Rather than seeking to explore it in a nuanced way, people have taken rather rigid positions.

On the one hand, there are those like the Bowles-Simpson Commission. The Commission takes the view that almost any tax expenditure is some sort of loophole that should be closed. In this vein, they take adopt the position and language that these are special interest loopholes and that closing them will lead toward revenue increases almost equal to the amounts stated in Treasury and the Joint Committee on Taxation’s (JCT’s) tax expenditure analysis. For example, the Commission’s illustrative proposal of eliminating the tax-exemption for interest

15 *Id.* at 5-6.
16 [Bowles-Simpson](#) supra note 1 at 31.
17 [Buckley](#) supra note 4 at 256.
on state and local government bonds does not examine the nuance involved, but instead just eliminates it for any new debt issued.\textsuperscript{18} It thus takes a rather harsh view on any tax expenditure. This particular harsh viewpoint is contrary to the idea that Surrey and McDaniel originally espoused in their work.\textsuperscript{19} Different tax expenditures have differing justifications with differing validity. Different tax expenditures are differentially effective. Furthermore, just repealing tax expenditures as they suggest may not increase revenues as much as they state.\textsuperscript{20} Additionally, contrary to the idea of them serving as special interest loopholes, tax expenditure repeal may not always be progressive.\textsuperscript{21} Thus, a true analysis and attempt to raise revenue via the repeal of major tax expenditures may not be as good for the revenues in our budget as Bowles-Simpson and many progressives believe.

On the other side though, there are those who make a substantive distinction between tax expenditures and ordinary expenditures, even though economically they are the same. These individuals thus support a tax credit, deduction, or exemption for something where they would not accept a direct subsidy. Two recent examples help crystalize this error.

The first is a spat between Grover Norquist and Senator Tom Coburn. While not an income tax “tax expenditure” in the Surrey-McDaniel model,\textsuperscript{22} the ethanol tax credit echo many of the ideas Surrey and McDaniel discuss, and it caused a rift between the two who are normally

\textsuperscript{18} Bowles-Simpson at 31.
\textsuperscript{19} Surrey and McDaniel \textit{supra} note 4 at 5.
\textsuperscript{20} See Buckley \textit{supra} note 4 at 259 (stating that for individual tax expenditures the estimates overstate the revenue potential, particularly since tax expenditure analysis is static while revenue projections by JCT use some microeconomic feedback models). \textit{See also} Part III.D.1. \textit{infra}.
\textsuperscript{21} See id. at 264-65 (stating that progressivity analysis should look at the tax rate and not just the percentage of which taxpayer bracket gets most of the tax break in dollar terms as distribution tables tend to show).
\textsuperscript{22} This is because the ethanol tax credit is a credit for an excise tax rather than an income tax, though one could come up with a similar conceptual idea for an excise tax base. Buckley \textit{supra} note 4 at 257.
allied. Coburn took the side more akin to Surrey and McDaniel’s concept of deviations from the base as equivalent to a direct expenditure, while Norquist in his anti-tax fervor stated that it was instead a massive tax increase.\textsuperscript{23} It was one of the few strange frictions between the two men. Norquist’s view though, that tax expenditures are tax cuts, holds particular sway though, because he has evangelized and himself wields power with the anti-tax pledge that many Members of Congress have signed.\textsuperscript{24}

The second example comes from a recent Supreme Court ruling. In \textit{Arizona Christian School Tuition Organization v. Winn}, Justice Kennedy found that a taxpayer had no standing to sue in federal court on a First Amendment Establishment Clause Claim regarding a tax credit Arizona instituted for those who spent money on private tuition at religious schools.\textsuperscript{25} While the contours of the First Amendment and standing arguments are outside the scope of this paper, Justice Kennedy’s reasoning for denying standing to the plaintiffs lies on the notion that a tax expenditure is fundamentally different from a direct appropriation.\textsuperscript{26} Of course, like much of the standing debate, there may be a flavor of result oriented adjudication, but the fact that such

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\item \textsuperscript{23} Michael Munger, \textit{Tax Expenditures: Fiscal Indulgence}, \textit{THE ECONOMIST: DEMOCRACY IN AMERICA BLOG} (Jul. 27, 2011, 21:48)
\item \textsuperscript{24} The pledge reads:
I. _____, pledge to the taxpayers of the (____ district of the) state of ______ and to the American people that I will: ONE, oppose any and all efforts to increase the marginal income tax rate for individuals and business; and TWO, oppose any net reduction or elimination of deductions and credits, unless matched dollar for dollar by further reducing tax rates.
\textit{What is the Taxpayer Protection Pledge?}, AMERICANS FOR TAX REFORM, http://www.atr.org/taxpayer-protection-pledge (last visited Apr. 9, 2012) . Note that the second part of the pledge requires that if one eliminates a tax expenditure there must be a dollar-for-dollar reduction in tax rates. Currently 238 Members of the U.S. House of Representatives and 38 Members of the U.S. Senate have signed the pledge.
\item \textsuperscript{25} Arizona Christian Sch. Tuition Org. v. Winn, 131 S. Ct. 1436, 1449 (2011).
\item \textsuperscript{26} See e.g., \textit{id.} at 1447-48 (stating that there is a major distinction between a tax expenditure and a direct spending matter as the former is not compelled against the taxpayer’s wishes).
\end{itemize}
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rhetoric can even be deployed shows how such distorted views on tax expenditures affect either the Court or its audience in the broader public.

These two countervailing forces have muddied the tax expenditure debate into a screaming match. Ultimately, given the need for both increased revenue and spending cuts, there will be growing pressure on tax expenditures. But, since our rhetoric is cramped so too is our thinking, which will likely lead toward great problems as we move forward. The next section examines a better way to discuss tax expenditures and the goal of tax reform to raise revenue by looking in depth toward one particular example, the exemption of interest payments on muni bonds from taxable income.

III. The Problems of Tax-Exempt Muni Bonds

Even if subsidizing the ability of subnational governments to borrow at a lower rate to finance capital projects is a justified goal, tax-exempt munis are ineffective means toward that end. To understand completely the problems of tax-exempt muni bonds, this paper will first define them and give a short historical background. It will then outline some of the problems. First it will examine the efficiency problems. It will then address distributive justice concerns. It will close with problems of administrability, but that term will be broadened to include issues of transparency and the inability for anyone to adjust the level of the subsidy.

A. An Explanation and History

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27 See, e.g., BOWLES-SIMPSON at 31 (showing some of the tax expenditures to eliminate).
28 Buckley supra note 4 at 269-70.
Tax-exempt munis are bonds where the bondholder pays no tax on the interest income. According to I.R.C. § 103, a bond issued by any state (including D.C. and the Territories) or political subdivision thereof, qualifies for this tax preference. The regulations define a political subdivision of a state as either a municipality or some other entity exercising sovereign powers of a state. While tax-exempt bonds may finance any government activity, including capital projects and general operating expenses of the government, there are some limitations on activities that government bonds may finance.

The subsidy arose by accident. In 1895 in *Pollock v. Farmers’ Loan and Trust Company*, the Supreme Court held that the taxation of interest income on munis was unconstitutional. The Court explicitly overruled *Pollock* soundly in 1985 in *South Carolina v. Baker*, holding that such taxation is fine and does not violate the intergovernmental tax immunity doctrine. Thus, now the federal government may tax such interest, if it so desired.

But, because of path dependency, where a small chance event swells into something that has become a settled expectation upon which whole systems are built, subnational government units got accustomed to such a subsidy, and indeed the tax exemption had become a means of subsidizing capital projects and other borrowing for states and localities. As a result, according to

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29 I.R.C. § 103.
30 I.R.C. § 103(c).
31 Treas. Reg. 1.103-1(b).
32 See I.R.C. § 141 (defining bonds issued by a government but used for certain activities, like a bond to finance a profit making business, as a private activity bond that may not get the tax-exemption unless qualified under certain rules, for example used by a 501(c)(3) for their capital projects), Treas. Reg. §§ 1.141-1 – 1.141.9 (outlining the tests that determine whether it is a private activity bond and whether it meets that test). I.R.C. § 103 not only excludes unqualified private activity bonds, but also arbitrage and unregistered bonds from the tax exemption on interest income.
a joint study by the Congressional Budget Office (CBO) and the Joint Committee on Taxation (JCT), between 1997 and 2007 about $1.3 trillion of these bonds were issued by subnational governments.\textsuperscript{35} They are the main ways in which infrastructure and other capital projects are financed in this country.\textsuperscript{36} The market that developed then remains large and serves a key role in allowing state and local government infrastructure development. Thus, the accidental subsidy has become a key way for the federal government to partner with subnational units to finance capital projects and infrastructure.

B. The Efficiency Problem

Even if there is a more valid justification beyond their accidental history, tax-exempt munis suffer from an inability to efficiently deliver the subsidy to subnational government units. There is also the problem of the limited market of purchasers, something that caused problems during the 2008 financial crisis.

1. Revenue Raising Inefficiency and the Subsidy Reduction

One of the greatest problems of tax-exempt bonds is that they are an inefficient way to deliver subsidy, because they lose more revenue to the federal government than subnational government units receive in subsidy. This type of inefficiency is called in this paper revenue inefficiency. According to the joint CBO-JCT report, only about 80% of the tax expenditure amount directly subsidizes the state or locality, i.e. $1 of lost revenue results in about $0.80 in subsidy to subnational governments.\textsuperscript{37} If that is the case then, according to their analysis $26

\begin{footnotesize}
\begin{enumerate}
\item[CBO-JCT] supra note 5 at 19.
\item[Id.] Id. at 25-28.
\item[CBO-JCT] at 34.
\end{enumerate}
\end{footnotesize}
billion of the $132 billion in tax expenditure from this item between the years of 2008-2012 was lost to taxpayers and not “given” to subnational governments.\(^{38}\) Thus, there is a great deal of inefficiency. This section seeks to explain how this revenue raising inefficiency arises from the basic structure of tax-exempt munis.

A useful way to measure the revenue inefficiency is using the implicit tax and related metrics.\(^{39}\) This metric can be a little confusing, so it is worth going through it in some detail. Contrary to its name, the implicit tax is not a tax.\(^{40}\) The federal government receives nothing from it. Instead it is the measure of the difference between the rate of a similar grade taxable bond and a tax-exempt bond, and it thus measures the amount of subsidy to the subnational government when it issues a tax-exempt bond. It is defined in the following equation, \((1 - \theta_T)R_T = R_M\), where \(\theta_T\) is the implicit tax, \(R_T\) is the bench-mark rate interest rate, which is pre-tax interest rate of a taxable bond, usually either U.S. Treasury or a comparable quality corporate bond. \(R_M\) is the rate of return of a comparable quality and maturity tax-exempt muni bond.\(^{41}\) The higher the implicit tax then, the greater the subsidy to the subnational government. The lower the implicit tax, the weaker the subsidy.

Comparing the implicit tax to a taxpayer’s marginal tax rate (MTR) also shows the tax benefit she receives, and the lost revenue to the federal government. When the implicit tax rate is greater than an investor’s marginal tax rate, she should not invest in that vehicle, because the after-tax rate of return on the taxable investment is greater than that of the tax-free muni. If the

\(^{38}\) Id.


\(^{40}\) Id. at 13 n. 2. It seems tax people enjoy really confusing terms.

implicit tax equals the MTR for the investor, she is indifferent in investing. If it is below, then the investor actually saves money by taking the lower-interest paying tax-free muni bond.

The revenue inefficiency metric arises by taking the difference between the implicit tax rate, and the highest individual MTR, which statutorily is set at 35%.\textsuperscript{42} If the subsidy is perfectly efficient, the implicit tax should equal the top individual MTR. If it is inefficient, then the implicit tax is lower than the top MTR, and the greater the gap between an implicit tax rate and the top MTR, the greater the revenue inefficiency.

Thus, looking at the implicit tax, one can easily get a rough estimate of the subsidy’s revenue inefficiency. A high implicit tax thus means that there is likely a fair amount of subsidy going to subnational governments with a relatively low amount of revenue loss and a lower implicit tax means a low amount of subsidy with a greater amount of revenue loss.

Data on the implicit tax reveals the revenue inefficiency of the subsidy. During the range of years of 1991-2010, the implicit tax rate on munis when compared to Treasury bonds averaged about 19.22%, while comparing to AAA corporate bonds averaged 27.68%.\textsuperscript{43} With respect to Treasury Bonds, the implicit tax has a low 3.98% to a high of 26.70%, while when compared to corporate bonds they have a low of 22.32% and a high of 33.97%.\textsuperscript{44} Each of these is lower than the top MTR, and in some years it is much lower that the top MTR. That means during those periods the federal government loses a fair amount of revenue with little benefit to cities and states.

\textsuperscript{42} I.R.C. § 1.
\textsuperscript{43} Poterba & Verdugo \textit{supra} note 41 at 593.
\textsuperscript{44} \textit{Id.}
Understanding how this revenue inefficiency and a high implicit tax arises from the very nature of these tax-munis is best explained by an example. Imagine that there is a muni bond market of 3 people: Andrew, Carmen, and Mike, all of whom have $1,000 to invest in either this muni market or in some other investment vehicle and who have marginal tax rates of 35%, 25%, and 10% respectively. Suppose that the city of Cabot wishes to sell a bond of $1,000 in this market, for which the going taxable equivalent rate is 10%. In order to get Andrew to buy the bond, it must pay him $65 + ε in interest, which is 65% of the $100 pre-tax interest of a similar corporate bond. In this situation there is nothing incredibly odd.

Now assume that two cities, Cabot and Eliot, wish to issue $1,000 bonds simultaneously. Here though, Andrew can only purchase one $1,000 bond. To induce Carmen to purchase at well though requires a higher interest rate paid by both Cabot and Eliot. Indeed, they are unable to price discriminate, as they do not know who has what marginal rate. Thus, they will pay $75 + ε in interest on their bonds, and Andrew and Carmen will buy the bond. It is here though that the trouble brews. A similar taxable bond investment for Andrew would only yield him $65 in interest after tax. Thus, Andrew gets a $10 windfall on interest payments.

The situation is even worse when a third city, Kahala, wishes to issue a bond. Now the implicit tax rate is determined in the same way. Again, the three cities, which all have equal credit rating and issuing the same type of bonds, are entirely unable to discriminate between Andrew, Carmen, and Mike. They need to get all three of them to purchase their bonds. As a result, the interest paid on the bond must be enough to get Mike to purchase it, i.e. any one of the

\[ \text{Interest before tax for such a bond is }$100. \]

\[ \text{Interest after tax for such a bond is } (1 - 0.35) \times 10\% = 6.5\%. \]

\[ \text{The Greek letter } \varepsilon, \text{ or epsilon, represents an infinitesimally small number, like }$0.01, \text{ to make the individual no longer indifferent.} \]

\[ \text{The example is a close adaptation to Johnson supra note 39 at 15-21.} \]
three city’s bonds must pay an interest of $90 + \epsilon$. Under this situation, Andrew gets a windfall of $25 and Carmen gets a windfall of $15 when compared to a similar taxable bond.

The example above is simple, but gets to the point, if the supply of municipal bonds exceeds the demand of top marginal rate taxpayers, then bonds must have an increased interest rate. Additionally if there are other investments for potential buyers of the bonds that have tax preferences, like owner-occupied homes, that puts additional pressure on the muni market to increase their interest rates, which lowers the implicit tax.\textsuperscript{48}

There are a few limitations to the example and the implicit tax analysis. First, it assumes rational investors. That may not be the case.\textsuperscript{49} Second, and relatedly, it assumes that the only purpose people would invest in these bonds is as a way to maximize returns within a balanced portfolio in an after-tax sense, but perhaps people may be drawn to tax-exempt munis for a social benefit. Though these limitations are real, the overall effects, given the data presented by Poterba and Verdugo shows that the effects of these deviations from the standard rational actor assumption are minimal.\textsuperscript{50}

Revenue inefficiency is a major problem with tax-exempt munis. But that is not the only efficiency problem. There is also a set of economic inefficiencies, which the next section covers.

2. Economic Inefficiency: Distorted Behavior and Limited Buyers

\textsuperscript{48} Johnson \textit{supra} note 39 at 18-19.
\textsuperscript{49} \textit{See generally} Daniel Kahneman, \textsc{Thinking Fast and Slow} 339-46 (2011) (discussing how often individual investors often narrowly frame issues, which in turn gives rise to loss-aversion, a sense that a loss is far worse than a gain; mental accounting, where one segregates money into separate categories for no real purpose; and the sunk-cost fallacy, where people dwell on past sunk costs and losses instead of analyzing on future opportunity costs).
\textsuperscript{50} Poterba & Verdugo \textit{supra} note 41 at 600 (showing that it is mainly individuals in the upper individual income bracket holding these bonds).
The subsidy from tax-exempt munis also creates major economic inefficiency. It does that in two major ways. First it distorts the investment behavior and these distortions generate a fair amount of deadweight loss (DWL) as people substitute one form of investment for another for purely tax reasons.\textsuperscript{51}

To explain this point, return to our mythical land. Suppose that only the cities of Cabot and Eliot issue bonds again. But Butterfly Corp. is also offering an investment of a share of preferred stock that pays a yearly dividend of $108 and costs $1,000. Further assume that it does not qualify as a qualified dividend to get the special reduced rate and thus is taxed at the ordinary income marginal tax rate.\textsuperscript{52} If the bonds were taxable, Andrew would purchase the Butterfly Corp. stock. But when Cabot and Eliot’s bonds are tax-exempt, the after-tax yield for the Butterfly Corp. stock is $70.20 for Andrew, which is less than the $75 tax-free interest payment. Hence, Andrew does not invest in Butterfly Corp., and the capital is diverted to the City of Cabot to use on their less valuable capital project. This switch, for purely tax reasons and not economic rate of return reasons, is the source of the economic inefficiency.

The economic inefficiency though not only distorts investment choices of individuals, but it also limits who holds these bonds. The holders of these bonds tend to be individuals who have high marginal tax rates, in other words high-income people.\textsuperscript{53} The problem is that many of them do not like the longer maturities.\textsuperscript{54} Indeed, a 30-year time horizon is often too long for an individual investor to lock-up funds, but often that is the proper time horizon for many capital

\textsuperscript{51} Johnson \textit{supra} note 39 at 17.
\textsuperscript{52} This assumption is made to simplify the example and make the math work. Technically, under I.R.C. § 1, the rate for qualified dividends is actually 15%, which equals the capital gains rate. That said, historically, it fell at the top marginal rate.
\textsuperscript{53} Poterba & Verdugo \textit{supra} note 41 at 601-602;
\textsuperscript{54} Dan Seymour, \textit{BABs: The Last Pillar Standing, Market on Edge As Deadline Looms}, \textit{The Bond Buyer}, Nov. 29, 2010 at 1.
infrastructure projects. Furthermore, the large institutional investors, like life insurance companies, pension funds, and foreign entities, who find such a time horizon palatable, do not want tax-exempt munis, because they of course face a marginal rate of 0%. Thus, historically, the tax-exempt yield curves then have been much steeper than Treasury yield curves.

With some financial liberalization and creativity, new means were created to push the yield curve down. But starting in 2007, each of these began to unravel, and by 2008 the most vanilla of all of these various means, bond insurance, took the final hit as the companies issuing them fell during the credit crisis.

When the crisis hit then, everything evaporated. If one’s income is declining, one’s income tax bill also falls, and thus means to limit taxable income become less necessary. Also as stated in the previous paragraph the market for the longer-term products collapsed, and as a result of both of these factors no one then would buy long-term tax-exempt munis. Yields spun out of control, and municipalities could not issue debt.

Thus, the limited market presents another economic inefficiency problem, a lack of robustness and stability. It also leads towards unusual and mismatched time horizons. Given that a crisis like the one we saw in 2008 is probably more common than we realize, the reliance on a narrow base of investors and highly exotic and hedged products creates a dangerous situation.

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55 Id.
56 Michael Decker, Commentary, Build America Bonds: An American Success Story, at 35.
57 Seymour supra note 54.
58 Id. Some examples were tender-option bond arbitrage (TOB) funds, which were used to buy short term bonds which were then reinvested into longer-term bonds and hedged against after tax rates like LIBOR; Auction Rated Securities (ARS), which were long-term paper that had an interest rate that reset at auction; Variable Rate Demand Obligations (VDRO), which were long-term paper with interest rates that would vary, and if no one bought them the municipality or a bank would repurchase (a put); and bond insurance. Id.
59 Id.
60 Id.
61 Decker supra note 56.
Yet, the structure of the subsidies themselves essentially means that such a move away from dangerous hedging that results from the narrow base cannot happen, and thus, these bonds are still vulnerable to freezes in the market from these fat-tailed events.

C. Equity: Distributive Justice Concerns

Like many other tax issues, the issue of equity arises. Traditionally tax policy has focused on two important yet distinct forms of equity. The first is horizontal equity. That means similarly situated taxpayers should pay similarly situated taxes.\(^{62}\) In this particular case, that concern is less problematic than in some other tax expenditures.\(^{63}\) The second is the notion of vertical equity. That is the idea that as someone earns more money his tax rate, the amount of tax as a percentage of income or wealth, should increase.\(^{64}\) This arises, often, out of the notion of the declining marginal utility of money or wealth.

Vertical equity as normally discussed in taxation then is a useful principle, but it is often unclear. For example, payroll taxes represent a hugely inequitable taxation system, as they are the same flat rate from the first dollar earned, and for some of them phase-out above $100,000. The tax burden is regressive. Yet, like so much of what this paper argues, one cannot just view taxation in a vacuum. Isolation is important, but so is interaction with greater parts. These payroll taxes fund what are generally considered to target rather progressive ends quite directly, and that

\(^{62}\) Graetz & Schenck, supra note 12 at 28.


\(^{64}\) Gruber supra note 12 at 609 (stating that marginal utility decreases as consumption ability increases. Given that Haig-Simons defines income as the potential for consumption, they are essentially as income increases marginal utility decreases).
are the entitlements of Social Security and Medicare Part A, which is the hospital insurance component of the program.

To sharpen vertical equity, notions of distributive justice are useful. Particularly important is the work of John Rawls.\textsuperscript{65} While going through the philosophical foundations of his work and developing a full defense of it is beyond the scope of the paper, he provides, perhaps one of the strongest framework that this paper will adopt as a means for examining this idea.

Rawls’s main principle along this line is his second principle of justice, better known as the Difference Principle. He formulates it in the following language,

Social and economic inequalities are to be arranged so that they are both (a) to the greatest expected benefit of the least advantaged and (b) attached to offices and positions open to all under conditions of fair equality of opportunity.\textsuperscript{66}

Rawls’s goal, of course, is to determine general ideas of justice upon which to structure major institutions. By these he means political constitution and the principal social and economic arrangements.\textsuperscript{67} The tax and budget system though are key toward these ends, because in many ways they are the primary levels for states and others to nurture such economic arrangements, even though Rawls himself never directly addresses it in a real way in his classic work.

Even with this richer sense of vertical equity though, tax-exempt munis raise serious concerns. The key concern, of course, arises from those individuals who purchase them and thus get the tax break. These tend to be individuals who are rather wealthy and thus are looking for a

\textsuperscript{65} Rawls’s theories and writings have a great deal of acceptance within the world of political and ethical theorists. See, e.g., Christine M. Korsgaard, \textit{Christine M. Korsgaard: Internalism and the Sources of Normativity}, \textit{Constructions of Practical Reason: Interviews on Moral and Political Philosophy} 51 (Herlinde Pauer-Studer ed., 2002) (stating the importance of Rawls’s theories for political liberalism and ethics, and the general sense that he has answered the big questions).


\textsuperscript{67} \textit{Id.} at 6-7.
way to shelter income.\textsuperscript{68} That said, the Difference Principle could save these bonds if the exemption allowed cities and states to help finance capital projects that benefit the least well off.

In one way, tax-exempt bonds do have something that helps on difference principle lines they help to keep state and local taxes lower as states and localities do not have to raise as much money to finance these projects. Given their more regressive structure than the federal income tax system with reliance on consumption taxes, user fees, and fewer brackets in the income tax, these are regressive by any measure, and thus avoiding them is difference principle aiding. But, even if this is the case, the means for doing this is horribly inefficient, especially if the implicit tax is as low as it is stated in the previous sections.

The other question of course is what subnational governments fund with these bonds. Usually the proceeds of these bonds go to fund public goods and infrastructure. But, on the margins, it is highly unlikely that the projects are designed with an aim toward helping those who are the least well-off. Indeed, given their political access and ability to participate, capital projects are more likely to help those who are best off.\textsuperscript{69} If squeaky wheels then get oiled more frequently, it seems unlikely that those worst off will get capital projects that overall make them better off, like for example a better school.

These distributive justice concerns are particularly salient at this point in time. The talk of Occupy Wall Street (OWS) has some hints of Rawls’s theoretical ideas with its focuses on the inequities of the top 1% of the population getting all the benefit of the growing economy while

\textsuperscript{68} Poterba & Verdugo \textit{supra} note 41 at 601-02; Johnson \textit{supra} note 39 at 13; CBO-JCT \textit{supra} note 5 at 34.

\textsuperscript{69} See Andrea Louise Campbell, How Policies Make Citizens: Senior Political Activism and the American Welfare State, 6 (2003) (stating that those who are better economically are known to participate more in politics).
the lower 99% stagnate or slip away. Additionally, a growing segment of the population sees this growing conflict between rich and poor that OWS has highlighted. Tax-exempt munis thus provide a great target for a renewed discussion on vertical equity and distributive justice, because of how they benefit the rich with uncertain levels of aid to the poor.

Thus, on this other dimension tax-exempt bonds create a problem. Given our growing concerns too of inequality in general, they seem to be a tax expenditure ripe for reform and reexamination. But their problems go beyond just efficiency and equity concerns. They also undermine transparency and democracy, and thus while easily enforceable and administrable within the tax code, create problems in a slightly larger sphere.

D. Administrability

The classic third category of tax analysis is often called either enforcement or administrability. That is the question as to whether we can actually enforce a certain tax structure with relative ease. Administrative burdens can often be quite large.

This particular tax expenditure seems quite administrable. Indeed, IRS need only police the definitional lines as to what qualifies for treatment under I.R.C. § 103. A deeper look at related code sections and regulations reveal a rather complicated system of rules, though on the whole within the tax system, their complexity is relatively small. If there is one area where tax-exempt munis seem to create few problems then, it is in the area of administrability.

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70 See Steven V. Mazie, Opinionator: The Stone: Rawls on Wall Street, N.Y. TIMES (Oct. 21, 2011, 2:32 pm) http://opinionator.blogs.nytimes.com/2011/10/21/rawls-on-wall-street/ (stating that Occupy has a similar feel to Rawlsian notions of Distributive Justice and that the protestors should consider him as a theoretic foundation for their project).

71 See generally, Richard Morin, PEW SOCIAL AND DEMOGRAPHIC TRENDS: RISING SHARE OF AMERICANS SEE CONFLICT BETWEEN RICH AND POOR (Jan. 11, 2012) (poll showing an overall sense of class division between the well off and working class Americans).
E. Democratic Goods and Harms

Tax-exempt munis harm democracy. They lack transparency and the subsidy is essentially uncontrollable by congress or the Treasury. These thus limit democratic participation and deliberation, creating a level of democratic harm.

1. The Transparency Problem

Tax expenditures in general create certain concerns when compared to direct expenditures, because there is a lack of transparency. Such problems are not some nefarious plot, but rather just arise from the nature of trying to predict a counterfactual to something that looks like inaction. It is much harder to determine causal relationships than if there were action, like a direct expenditure.

There are a host of assumptions that one needs to make. First there is the assumption regarding the “normal” tax base, some of which may appear to be problematic. But, even more harmful for using tax expenditure analysis is the static assumption that “Taxpayer behavior is assumed to remain unchanged for tax expenditure estimate purposes.” Unfortunately, when legislation is proposed and scored, the revenue estimate takes into account microeconomic behavioral responses.

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72 See generally Rosanne Altshuler & Robert Dietz, Reconsidering Tax Expenditure Estimation, 64 NAT’L TAX J. 459, 462-81 (for a complex and detailed analysis as to what the “normal” tax base entails and how some of them, like the standard deduction and personal exemptions not treated as a tax expenditure while the EITC is, makes little sense, and how such definitions ignore sunset provisions and the specter of the AMT).

73 Buckley supra note 4 at 259 citing JOINT COMMITTEE ON TAXATION (JCT), ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2007-2012 JCS-3-07, 8 (Sept. 24, 2007).

74 Id.
because when the tax burden increases, individuals do change their behavior in response.\textsuperscript{75} Furthermore, even revenue estimates lack the macroeconomic feedback and changes in national income that arise from changes in tax policies.\textsuperscript{76} Finally, tax expenditures often interact together, and thus the tax expenditure estimates, even if they accounted for microeconomic effects, cannot be summed.\textsuperscript{77} In many instances, these interactions lead toward a further overstatement of tax expenditure revenue gains.\textsuperscript{78} This last point seems to be missing in the analysis by the Bowles-Simpson Commission.

In the case of this particular tax expenditure, the range of revenue loss when one changes certain behavioral assumptions is rather stark. In their paper James M. Poterba and Arturo Ramírez Verdugo explain the effects of five different assumptions on how taxpayers will change their behavior if the tax-exemption for muni bonds were repealed. These different behavioral assumptions are: (1) taxable bond substitution, (2) proportional substitution, (3) equity substitution, (4) tax-efficient substitution, and (5) debt repayment.\textsuperscript{79} They use the National Bureau of Economic Research’s TAXSIM program to generate the modeling.\textsuperscript{80}

In their analysis, Poterba and Verdugo find a range based on the assumption from $14.0 billion for the pure substitution with taxable bonds, which is the static estimate, to a low of $8.2 billion for proportional substitution.\textsuperscript{81} They do state that the low-end estimate assumption is not a particularly likely pattern, because it implies that these taxpayers use tax-exempt bonds for

\textsuperscript{75} Id. See also Altshuler & Dietz \textit{supra} note 72 at 481-83 (they provide a simple graphical example as to how tax expenditures overestimate revenue gain when compared to use of microeconomic modeling for behavioral change).

\textsuperscript{76} \textit{Id.} at 481.

\textsuperscript{77} \textit{Id.} at 484.

\textsuperscript{78} \textit{Id.} at 484-85.

\textsuperscript{79} Poterba & Verdugo \textit{supra} note 41 at 597.

\textsuperscript{80} \textit{Id.} at 598.

\textsuperscript{81} \textit{Id.} at 604, 606.
liquidity purposes.\textsuperscript{82} The two middle results give estimates around $8.9 billion (pure equity substitution) and $9.9 billion (tax-efficient substitution).\textsuperscript{83} While none of these numbers are small, particularly in the world of tax expenditures, there is a huge difference between an estimate of revenue loss on the order of $14 billion versus even the $9-10 billion range for what may be the most likely portfolio substitution case. The overestimation of this tax expenditure thus is large.

This magnitude estimation concern reveals two key problems with this and many other tax expenditures. One is what Buckley points out about how revenue raised by repeal of a tax expenditure, particularly one for individuals, is often overstated.\textsuperscript{84} But, even more problematic in the context of this particular tax expenditure, we do not really have a true handle on exactly how much the federal government is “spending” by subsidizing state and local government borrowing. As a result, it becomes incredibly difficult to have a good discussion of what is an optimal amount of intergovernmental transfer.

This lack of transparency in the amount that is actually forgone in revenues then makes this and many other tax expenditures incredibly difficult for us to discuss and analyze. It is but one seed of the administrability and democracy problem.

2. The Inability to Adjust

We also lack the ability to directly control the subsidy rate of tax-exempt munis. As the examples in Part II.B. of the bond market above shows, the subsidy level really depends on both supply and demand of the market itself, but it also depends on what other tax-preferred

\begin{itemize}
\item \textsuperscript{82} Id. at 604.
\item \textsuperscript{83} Id. at 604, 606.
\item \textsuperscript{84} Buckley supra note 4 at 259.
\end{itemize}
investment tools there are.\textsuperscript{85} Congress and Treasury do not have the ability to set an implicit tax rate, and thus the level of subsidy, by fiat, and instead there are a series of highly complicated interactions that determine the rate of subsidy and revenue loss.

If instead, there were an actual positive policy, rather than a negative exemption, like a tax credit or some other subsidy payment, the federal government could adjust the rates to provide the same amount of subsidy at lower cost, increase the amount of subsidy without incurring additional revenue loss, or even reduce the subsidy from its current level to tighten the supply and encourage better fiscal control with the subnational governments.\textsuperscript{86} But, given the situation now, it is difficult for the federal government to increase the subsidy if it determines it is too low, and structures to reduce the subsidy are likely to be quite complicated or rather blunt.\textsuperscript{87} Furthermore, regulations to limit the use of these bonds for capital projects do not exist. Thus, the federal government has no true control on the amount of the subsidy or over what purpose the subnational government is borrowing the money.

From a democratic deliberation standpoint this lack of control is a harm. Rather than trying to reach a level of mutual agreement between the subnational government and the federal government, which in turn helps us to better delineate the role each unit of government plays in our federal system on these projects, the market just sets the rate of subsidy. Furthermore, if certain set of infrastructure projects need financing immediately because of some overarching national need, Congress is unable to coax subnational governments to undertake these projects by providing better borrowing subsidy. Most importantly, because we cannot control it,

\textsuperscript{85} Johnson supra note 39 at 17, 19.
\textsuperscript{86} CBO-JCT supra note 5 at 35. CBO and JCT do not discuss the last scenario.
\textsuperscript{87} See Johnson supra note 39 at 50-51 where he suggests a bright line of not allowing interest greater than 65\% of the applicable federal rate and a bidding process for the right to issue such bonds. Such a process could likely be administratively difficult.
discussion of the issues about valuing this transfer system are almost entirely theoretical, without any bite, and that undermines our ability to really understand the benefits and pitfalls of federalism in this sphere.

3. Weakened Democratic Deliberation

As the parts above show, both the lack of transparency and the inability to control the subsidy rate weakens democratic deliberation. The above problems with this particular tax expenditure are amplified by the fact that we do not know truly how much they cost and the size of the subsidy to states is hidden. They thus harm both democratic citizenship and our ability to have a good discussion of the size of such an intergovernmental transfer.

Perhaps central to any idea of democracy is the ability of citizens to form meaningful opinions about policies put forward by the government.88 Without the information relevant at hand the opinions formed are often faulty, based on misunderstanding and assumptions.89

In the area of tax expenditures generally, citizens of the U.S. have a great deal of misunderstanding of them. Much of the general public somehow does not understand the very equivalence between direct spending program for their benefit and a targeted tax break.90 These beneficiaries of tax expenditures often, when first asked if they have benefitted from a government program deny that they have, though they claim they benefit greatly from tax expenditures like the home mortgage interest deduction.91 The survey also revealed that direct spending programs, but not tax expenditure benefits, made people more likely to agree that they

89 Id.
91 Id.
received government help in times of need.92 Furthermore, benefit from tax expenditures does not correlate in any way with a perception that one is paying her fair share or less than that amount.93 While the survey looks at tax expenditures generally, it is easy to see how the same arguments this data on opinions applies to tax-exempt munis.

This opinion distortion also has some particular problems when one focuses on the exemption of muni bond interest. Citizens of the nation are unable to form a clear understanding of exactly what states and localities benefit from the exemption because clear information about which subnational governments benefit from these subsidies are lacking. They are unlikely to be able to debate effectively how those resources should be allocated and even what the amount of the transfer the federal government should make to the states.

Given the problems with estimating the tax expenditure, the ability to form thoughtful opinions is further undermined. Even highly intelligent policy wonks, as shown by the Bowles-Simpson commission’s views, fail to comprehend that tax expenditures cannot be summed and that they may overstate the amount.94 If even the experts have such problems, then all the more that the average citizen or legislator will stumble and be unable to grasp the debate.

Thus, tax-expenditures generally, but particularly the exemption for muni bond income prevent an effective opinion formation. As a result, we get the cramped view stated in Part II.B. supra and do not have an effective discussion for workable policy solutions.

F. Problems with Full Repeal

92 Id. at 42.
93 See id. at 43-44 (stating that utilization of almost any tax expenditure, including far larger and more common ones like ESI did not change people’s view about how fair of a share they paid in taxes).
94 Buckley supra note 4 at 259, 262.
Overall, tax-exempt munis create significant efficiency problems. They are inequitable. They are democracy hindering. But even with these problems, full-scale repeal is likely problematic for numerous reasons as well. First, if it is justified for the federal government to partner with states and localities in the realm of financing capital projects, our attention should turn toward better ways for delivering the subsidy. That said, this assumption is quite strong and again outside the scope of this paper.

Yet, highly problematic tax expenditures must be changed carefully, as often repeal would create major collateral unforeseen effects. First, the distributional effects may not be what they seem. With tax-exempt bonds, the particular distributional impact is that it would shift the burden from the federal government to states and localities, which in turn would have to pass it on toward a higher tax or reduced services in some form. Since often these taxes are more regressive income or consumption taxes, on a difference principle analysis, full repeal may not solve the vertical equity problem that tax-exempt bonds create.

There are also settled expectations that have developed over this means of financing bonds. States and localities rely on the subsidy, and ending them may have them delay or stop capital projects, which may not be so desirable, given the horrific state of our infrastructure.\(^5\) It would drastically change the calculus of infrastructure projects’ valuation, and since many are public goods, there could thus be a decrease in welfare. Additionally, it could possibly cause a shock to the muni market that has become well developed over time and has put this subsidy into its pricing and interest scheme. Changing such expectations should at least be done with caution as a policy matter and these types of problems need to be better explored.

Third is the need for transition relief. In the period leading up to the passage of the Tax Reform Act (TRA) of 1986, Pub. L. 99-514, 100 Stat. 2085, a report by the Treasury Department discussed the need for transition relief. Transition relief is a tax provision that helps smooth changes in the Tax Code by avoiding, “windfall gains and losses and economic dislocations.” For example, a grandfather clause is one form of transition relief. But, the analysis today pushing for reform and arising from those who argue for repeal, including many of the simulations run by economists to help strengthen our analysis like Poterba and Verdugo, do not include transition relief, and instead look at immediate repeal or changes. That would likely reduce the revenue gains. In a program like the tax-exemption on munis, given their long history, transition relief could be quite extensive, at the very least including grandfathering in current bonds. That would mean that the current year’s estimate of tax expenditure or loss revenue is reduced down to zero. Transition relief may also do some very odd things regarding timing of these matters.

Thus, full repeal is likely not a viable option not just as a matter of politics, but as a matter of good policy. Instead we should seek a more effective and efficient alternative. The American Recovery and Reinvestment Act (ARRA) provided just that opportunity. Its ingenious idea born of the 2008 financial crisis: Build America Bonds (BABs).

IV. Build America Bonds (BABs): An Issuer Paid Tax Credit Bond

BABs represent a way around the problem of tax-exempt munis. Congress created them in the “American Recovery and Reinvestment Act of 2009,” (ARRA) Pub. L. 111-5, also known

96 Buckley supra note 4 at 262-63.

97 Id.

98 Id. at 263.

99 Id.

100 Id.
as the stimulus.\textsuperscript{101} There are actually two types of Build America Bonds. The first type is a tax-credit bond, which provides the bondholder a tax credit.\textsuperscript{102} The other is one where an issuer receives a subsidy on the bond structured as a tax refund payment.\textsuperscript{103} Both are BABs, but for the purpose of this paper, the latter form is what will be referred to as BABs. The former will be called tax-credit BABs.\textsuperscript{104}

This section will first start with a more detailed description of BABs and state some of the Obama Administration’s Proposals to tweak and reauthorize the program. It will then discuss how on each level they are superior to tax-exempt bond financing, mirroring Part III’s analysis of tax-exempt muni’s problems. Finally, it will close with a short comparison to tax-credit bonds, like tax-credit BABs.

A. Introduction to BABs

BABs are codified at I.R.C. § 54AA(g). Some of the requirements for a BAB are that they need to meet all the general requirements under I.R.C. § 103, meaning that they are issued by a proper subnational government entity.\textsuperscript{105} BABs are issued for capital financing of infrastructure projects, which is the most common use for tax-exempt munis. But, the interest on the bonds is taxable to the holder though unlike traditional muni bonds. Instead if it so elects, the issuer receives a refundable tax credit, on the date of the interest payments to the bondholder,

\textsuperscript{102} I.R.C. § 54AA(a)
\textsuperscript{103} I.R.C. §§ 54AA(g), 6431.
\textsuperscript{104} The technical term for the BABs defined by I.R.C. § 54AA(a) are tax-credit bonds, while those in I.R.C. § 54AA(g), which this paper calls plain BABs, are direct-pay tax-credit bonds. See CBO-JCT supra note 5 at 13-16.
\textsuperscript{105} I.R.C. § 54AA(d)(1)(A).
\textsuperscript{106} I.R.C. § 54AA(f)(1).
of 35% of the interest payment. Additionally, unlike traditional muni bonds, there is a limitation on the use of BABs. The proceeds may only be used for capital project financing. The provision allowing subnational governments to issue BABs expired on January 1, 2011.

In his FY 2013 Budget Proposal, President Obama proposed to make the BAB program permanent but without eliminating traditional tax-exempt munis. The proposal reduces the subsidy rate to 28% to make it roughly revenue neutral to the current size of the federal tax expenditure for tax-exempt munis. It also expands the uses for BABs. Under the President’s proposal, BABs could now be used for: (1) original capital financing, (2) capital project refinancing, (3) short-term governmental working capital purposes subject to a thirteen-month maturity limitation, (4) financing for 501(c)(3) organizations. These changes bring BABs even closer to the current uses for tax-exempt munis, with one significant limit, a subnational government cannot use it for operating expenses. It should be noted that the short-term governmental working capital is an operating measure, but it is highly limited because of the maturity limitation. These changes though have yet to be enacted into law.

BABs are an improvement over the current system of tax-exempt bonds on almost every dimension as explained below. They are more efficient. They have fewer distributive justice concerns. BABs do not create major administrative burdens when compared to tax-exempt munis. BABs are more transparent and easier for Congress to control the rate of subsidy. Finally, BABs

107 I.R.C. §§ 54AA(g)(1), 6431 (b), (d).
108 I.R.C. §§ 54AA(g)(2).
109 I.R.C. § 54AA(g).
111 GREEN BOOK supra note 110 at 12.
112 Id.
have done something that few alternatives to tax-exempt muni bonds have done in the strange world of municipal finance; they have sold well.

B. Efficiency Gains

By providing a direct subsidy payment to subnational governments from the federal government, and eliminating an item of tax preference for individuals, BABs move from the world of a tax-expenditure to a more direct expenditure program. Thus, the subsidy rate is more efficient. Furthermore, the distortions to investment choices and the market are greatly reduced, because the interest on BABs is taxable, and they have better yields.

1. Revenue Efficiency

BABs’ major efficiency gain stems from the fact that a dollar paid to a subnational government is a dollar of federal expenditure, rather than the a $1 of loss tax revenue equal to about $0.80 for tax-exempt bonds.\textsuperscript{113} This eliminates the problems discussed in Part III.B.1. regarding the implicit tax. Because they are fully taxable, there is no implicit tax. A BAB and a taxable bond of similar quality should have roughly similar interest rates and produce similar after-tax yields.

The subsidy amount also does not create a means for someone to get income in a tax preference way, because the subsidy is not at all linked to any tax benefit to an individual investor. Hence, there is no revenue loss too. Hence, BABs solve this revenue efficiency problem.

2. Economic Efficiency

\textsuperscript{113} Treasury BAB Report 2011 supra note 110 at 5.
Furthermore, BABs, because they are taxable, will not distort investment choices and thereby eliminate the problems of investment distortion and a limited base of borrowers. The reason that the distortion disappears is that the interest is fully taxable, and none of the pesky implicit tax analysis appears. The subnational government pays to a BAB holder a yield that is similar to a benchmark bond, like a Treasury or similar grade corporate bond, and the subsidy goes as a direct check from the federal government to the subnational government. The only factors then that should affect the rates of BABs are risks of default on the debt and revenue raising capacity of the subnational governmental unit.

Since there is no reason for an investor to substitute a BAB for a higher yielding investment because of tax purposes, the economic efficiency loss is minimized. Go back to the example in III.B.1. with a key modification. Andrew, Carmen, and Mike each have a marginal rate of 35%, 25%, and 10% respectively and each has $1,000 to invest. Cabot City this time is issuing a BAB of $1,000 with a 10% interest while Butterfly Corp. is offering $1,000 in stock that would pay a dividend of $108. Andrew will choose to purchase the Butterfly Corp. stock, as that investment has the higher after tax return ($70.20 for the stock and $65 for the bond). Thus, the bond does not distort his investment choices, because its interest is fully taxable.

Indeed, as currently structured with a 35% refund rate, BABs actually represent a windfall to subnational government units as their subsidy increases. Suppose again our three taxpayers: Andrew with a 35% rate, Carmen with a 25% rate, and Mike with a 10% rate each

\[114\] See Gruber supra note 12 at 594, 619-20 (stating that it is the substitution effect that creates deadweight loss, and thus one needs to use compensated elasticity). Of course, there may need to be higher federal income taxes to cover the costs of such spending, but even so, data suggests that the elasticity of taxable income at the top end of the tax range is quite low, between 0.57 to 0.17, which would imply that increasing top marginal rates to fund this program would not lead towards a major welfare distortion. Peter Diamond & Emanuel Saez, The Case for a Progressive Tax: From Basic Research to Policy Recommendations, 25 J. ECON. PERSPECTIVES 165, 171-72 (2011).
with $1,000 to invest are the bond market and the cities of Cabot, Kahala, and Eliot all issue BABs of $1,000 paying 10% interest per year, each taxpayer will see an after tax return of $65, $75, and $90 respectively, implying a total tax liability of $70. Under the current program each city though gets a payment of $35, for a total of $105 in refund payments. Thus, the windfall here goes to the cities. Of course, under the Obama budget proposal, each city would only get $28 in a tax-refund payment, for a total of $84, which is far closer to the actual revenue collected.

Just as importantly, BABs have likely broadened the investor base. As stated earlier, perhaps some of the biggest problems with the tax-exempt bond market is that it consisted mainly of high marginal tax rate individuals who were unwilling to purchase longer maturity bonds. Many of the larger players like foreign investors, nonprofit investors, and pensions funds did not invest in munis, because these investors had an effectively 0% tax rate.

First, are data from the Treasury Department’s study. The graph of the predicted yield curve is given below.

Figure 1: Predicted yields of BABs and tax exempt bonds

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115 Seymour supra note 54.
116 Id.
118 The graph is from id. at 9.
Using paired samples of BABs issued on the same day as tax-exempt muni bonds and running a fixed effects regression, Treasury determined that the yield on a BABs after the subsidy was lower than tax-exempt bonds, particularly further out on the yield curve.\textsuperscript{119} For a 30-year maturity tax-exempt bond, the interest was 476.3 basis points.\textsuperscript{120} A 30-year maturity BAB has a pre-subsidy rate of 603.9 basis points and an after subsidy rate of 392.7 basis points, which is equal to 65\% of the pre-tax amount.\textsuperscript{121} This is a rather steep 83.6 basis point reduction from the tax-exempt bond level.\textsuperscript{122} Even if the subsidy were reduced to 28\%, one should get for a 30-year bond an after subsidy interest rate of 434.8 basis points, which is still about 41.5 basis point reduction from the tax-exempt bond rate, which is still rather significant as interest rate reductions go.

\textsuperscript{119} \textit{Id.} at 7-9.
\textsuperscript{120} \textit{Id.} at 9. A basis point is a way to measure the interest rate on a bond. 100 basis points equal 1 percentage point. Thus a bond with a 5\% yield has a basis point measured yield of 500.
\textsuperscript{121} \textit{Id.}
\textsuperscript{122} \textit{Id.} at 8-9.
Another study by Andrew Ang, Vineer Bhansali, and Yuhang Xing also confirms Treasury’s results and point towards the base broadening by eliminating individual taxpayers with higher marginal rates. Overall the study shows that BABs have a basis point reduction of 54 from tax-exempt bonds.\textsuperscript{123} Indeed, the basis reduction they report is likely an understatement, because if BABs were not present, tax-exempt muni rates would be higher because that market would have to absorb the amount invested in BABs.\textsuperscript{124} Additionally, they show that BABs are not good investment for individual investors with a high marginal tax rates.\textsuperscript{125} They also represent an investment with higher returns, though slightly higher risks, to Treasury bonds and are competitive and attractive investment for larger institutional investors, particularly those exempt from U.S. income taxes.\textsuperscript{126} Thus, BABs help reduce borrowing costs by broadening the base, and making the market for muni bonds more liquid.\textsuperscript{127}

BABs broaden the base toward these institutional investors. These investors likely also have a time horizon that is closer to the longer-term maturities that are part of capital projects.\textsuperscript{128} Thus, BABs make more sense from a capital project financing side.

The BAB program then helped to stabilize municipal borrowing by coming into existence and that effect was also felt in the traditional tax-exempt muni market.\textsuperscript{129} As the program came toward an end, and given an inability for Congress and the administration to renew the program,

\textsuperscript{123} Andrew Ang, Vineer Bhansali & Yuhang Xing, \textit{Build America Bonds}, J. OF FIXED INCOME, Summer 2010 at 67, 71.
\textsuperscript{124} \textit{Id.} See also Seymour \textit{supra} note 54 (citing George Friedlander of Citigroup stating using BABs saves an issuer 100 basis points in interest and that even if one does not use a BAB, about 50 basis points are saved because they divert supply from long-term tax exempt bonds) and Decker \textit{supra} note 56.
\textsuperscript{125} \textit{Id.} at 71-72.
\textsuperscript{126} \textit{Id.} at 71.
\textsuperscript{127} \textit{Id.}
\textsuperscript{128} Seymour \textit{supra} note 54.
\textsuperscript{129} \textit{Id.}
the product began to disappear and subnational governments had to turn to the traditional forms of borrowing in tax-exempt bonds. The yield curve for tax-exempt bonds themselves jumped upward as the BAB program came to an end without a reauthorization on the horizon, because there was both an excess supply of tax-free debt and a decline in the demand. News reports suggest that subnational governments are finding some workaround to mitigate this result, but again they are limited in effectiveness and may even be risky.

BABs have done an excellent job in stabilizing the market and expanding the pool of investors. They have lower yields than similar tax-exempt bonds. They even helped push down the yields of tax-exempt bonds in the longer maturity ends. They also hit a more appropriate time horizon for capital project financing, when those projects are things like bridges and airports that are meant to last for 30 or more years.

C. Vertical Equity and Distributive Justice

BABs also do a better job on distributive justice grounds. Recall that a better measure for vertical equity is not just merely whether the tax is regressive but to see if the inequity created helps to improve the condition of those who are worst off.

In the case of BABs though, the inequality is rather limited. At the very worst, it represents as massive transfer from rich individuals to corporations, foreign entities, nonprofit endowments, and pension funds, and thereby does not change the situation. That said, pension funds do generally benefit a wider swath of the income scheme, as they are often an important

\[\text{RAWLS supra note 68 at 72.} \]

\[\text{Ang, et. al. supra note 123 at 71.} \]
employee benefit for middle class employees. Furthermore, even the corporate tax reduction may not be so regressive either. The incidence of the corporate tax often is assumed to fall almost exclusively on the holders of capital, but a more likely assumption is that it often falls on labor and consumers more heavily in the long-run given the relative elasticity of demand.  

Since BABs are not a legal “shelter” for high marginal tax rate individuals, the difference principle problems disappear. The issue of what exactly the bonds finance is less important, since the tax structure of BABs does nothing to exacerbate further the existing inequalities. Thus, on this important, and often forgotten ground of tax policy, BABs also improve on the problems of tax-exempt munis.

D. Administrability

BABs also streamline tax administration. According to the Treasury Department, by focusing on governmental issuers they reduce some of the administrative burdens when compared to tax-exempt bonds that require the analysis of each investor as the tax intermediaries.  

Treasury and IRS already have the capacity in place to make a switch to BABs from tax-exempt bonds. Currently there are already a fair amount of compliance requirements put forth in the tests in I.R.C. § 103 and the accompanying regulations relating to tax exempt bonds in terms of policing what qualifies as such a bond. Of course, new administrative requirements, like the matter of limiting BAB usage further or creating differing subsidy rates based on projects could

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135 GRUBER supra note 12 at 713 (stating that corporate tax incidence is uncertain but likely to fall on labor and consumers as well as capital).
increase the administration costs, but unlike many other tax expenditure reforms, these are not too much further afield than what is going on in Treasury.

The current payments of BABs have been both accurate and timely. IRS has established quite rapidly the means for ensuring that the payments went to known bond issuers, to the right issuers, and at the right amount.\textsuperscript{138} Almost all payments reviewed by a sample by the Treasury Inspector General for Tax Administration (TIGTA) showed that payments were made within 45 days, save one, which took longer because of a concern of duplication.\textsuperscript{139} Finally IRS has instituted some serious controls to prevent fraudulent or erroneous disbursements.\textsuperscript{140}

Furthermore, overall, to prevent improper use of BABs while balancing against overly punitive Treasury examinations, IRS has done a relatively decent job. In another review by TIGTA Treasury did have an effective compliance check questionnaire.\textsuperscript{141} It avoided overstepping the lines and requesting information that would lead toward an examination, which is a legal proceeding, while still asking for matters that suggest high-risk of noncompliance.\textsuperscript{142} The one deficiency of the report is that IRS did not have documented guidelines for developing and initiating compliance checks.\textsuperscript{143} Much of this arose, because of the time constraints in putting the program into place quickly.\textsuperscript{144} That said, IRS did respond that it was developing these

\textsuperscript{138} \textsc{Treasury Inspector General for Tax Administration, Recovery Act: Initial Build America Bond Subsidy Payments were Processed Accurately and Timely, 5 (2011) hereinafter TIGTA Payment Report.}

\textsuperscript{139} \textit{Id.} at 6.

\textsuperscript{140} \textit{Id.} at 7-8.

\textsuperscript{141} \textsc{Treasury Inspector General for Tax Administration, Recovery Act: The Direct Pay Build America Bond Compliance Check Has Yet to Result in Wide-Scale Examinations, 4-5 (2011).}

\textsuperscript{142} \textit{Id.} at 2-3, 4-5.

\textsuperscript{143} \textit{Id.} at 5-7.

\textsuperscript{144} \textit{Id.} at 6.
guidelines.\textsuperscript{145} This is relatively important issue even if it is minor and easily remedied technical matter, and it shows that IRS does at least have some understanding and capacity in place to administer this program, and possibly even a more complex BAB program effectively, particularly if given enough time to ramp up its procedures.

Thus, on the administrability issues, BABs are not that much of an increased burden when compared to tax-exempt bonds. They may even be more effective than traditional tax-exempt munis since less compliance is required on the taxpayer bondholder end. Even with these improvements though, the question is whether or not the market took up these bonds.

E. Democratic Goods

BABs, by shifting to a mechanism of directly providing a subsidy to states and localities, eliminate some of the hiddenness of tax expenditures. Gone are the weird estimates that one needs to make after the year to determine the amount of loss revenue. Instead, a dollar that the federal government pays out to a state or locality is a dollar of federal expenditure. There is a direct mapping between the two.

Shifting to this type of clear expenditure also makes the number more salient. This effect has some other positive matters. A tax expenditure, just given its strange nature conceptually and the problems in estimation is just not that salient. Unequal availability on this type of information creates a heuristic that prevents us from having an important discussion on our priorities, as stated above.\textsuperscript{146}

\textsuperscript{145} \textit{Id.} at 6-7.
\textsuperscript{146} See \textit{generally} KAHNEMAN supra note 49 at 129-36 (discussing experiments that show an availability heuristic, such that the more available information is about a phenomena, the more likely they think it occurs or affects them even if the actual probability of the phenomena occurring is much lower.).
Congress and other policy makers can even vary the level of the subsidy, unlike traditional tax-exempt bonds, which is left entirely up to the vagaries of the market. With an actual policy lever in place too, there can be a robust debate as to what is the proper amount of the subsidy given the amounts paid. Congress can then reduce the subsidy if it determines that there is an oversubsidization or increase it if it feels it is not enough. Congress could even create a variable schedule of subsidization based on some set of criteria, allowing for prioritization within the set of projects. Such a discussion too could possibly lead toward dialogue as to what kind of projects as a whole are of national priority.

Finally, unlike the current structure of tax-exempt bonds, BABs are far more limited and proposals to expand them start from this limitation. Even the President’s budget proposal keeps BAB mainly in the realm of capital expenditures. The only operating expenses that are allowed are for very short-term working capital expenses. Such a limitation prevents states and localities from hiding structural deficits too long through longer-term debt, as a 13-month maturity limitation keeps it off only until the next fiscal year before they must reissue a bond. Also given the administrative machinery that has arisen and should arise with a permanent BAB program, IRS should have the ability to enforce this mechanism. Thus, BABs also encourage greater fiscal responsibility than tax-exempt bonds as currently structured.

These aspects BABs then help the larger side of administrability, the overall administering of budgets and priorities. They eliminate the problems of the submerged state as well, which would aid revitalizing democracy.

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147 See CBO-JCT supra note 5 at 35 n. 11 (stating that tax-credit bonds can have a subsidy adjustment). See also TIGTA PAYMENT REPORT supra note 138 at 2.
149 CBO-JCT at 36.
151 Id.
F. Comparing to Tax-Credit Bonds: Sales and Issuance

Unlike other proposals to change muni bond financing, BABs actually have a successful sales record. This is especially true when compared to tax-credit bonds, which is the alternative solution considered.\textsuperscript{152} In almost every situation, BABs have outsold other products that sought to displace tax-exempt munis as the main form of investment, and thus it shows their superiority as a means to substitute and phase out tax-exempt munis.

According to data provided by the Treasury Department, states and localities issued a total of 2,275 BABs between April 2009 and December 2010.\textsuperscript{153} The total amount issued was $181.3 billion, which comprised 23.6\% of the muni bond market.\textsuperscript{154} Additionally every state issued at least one BAB.\textsuperscript{155} BABs too have filled in great roles for both small issuers like school districts to massive improvements like the major projects of the Bay Area Toll Authority’s project to build a new east span of the San Francisco-Oakland Bay Bridge.\textsuperscript{156}

BABs have also sold quite well relative to tax-credit bonds and the tax-credit BABs.\textsuperscript{157} Subnational government units do have the option, under the code whether to choose the tax-

\textsuperscript{152} CBO-JCT at 13-16 (describing tax credit bonds as the alternative to tax-exempt bonds for subnational government finance), Decker supra note 56.
\textsuperscript{153} Build America Bonds, U.S. DEPT. OF TREASURY, http://www.treasury.gov/initiatives/recovery/Pages/babs.aspx (last visited Apr. 9, 2012) hereinafter BAB Website. The website has a series of Excel Spreadsheet Data Sets which are used
\textsuperscript{154} BAB Website.
\textsuperscript{155} BAB Website.
\textsuperscript{156} Treasury BAB Report 2011 supra note 110 at 6.
\textsuperscript{157} Decker supra note 56.
credit BAB or the other BAB form.\textsuperscript{158} Given this ability and a similar subsidy rate, the actual evidence for sales of BABs have shown them to be far superior to that of tax-credit bonds.\textsuperscript{159}

Thus, on almost every account, BABs solve for many of the problems that arise under tax-exempt muni bonds. They outperform other options on sales. They are more efficient, equitable, and administrable. If phased in properly, it is likely that they can help make a shift in the way state and local governments operate debt financing and how the federal government plays a supporting role. That said there are some problems.

V. Small Problems with BABs

BABs do have some problems though, which hinder their effectiveness. Many of the policy concerns that arose during the program are easily allayed and answered. Two of the most important concerns are the allegedly high fees associated with issuing BABs and the fear of offset of a refund to satisfy a federal tax levy or a federal nontax debt.

A. Bond Origination Fees

One of the largest critiques of BABs is that they had incredibly high underwriting and origination fees. Bond issuers pay these fees the banks and other intermediaries to issue the bonds on the market.

According to the New York Times, an understated number for the funds collected by Wall Street from these fees is $700 million.\textsuperscript{160} In June, the Times found that issuers paid $6.55 per

\begin{itemize}
\item \textsuperscript{158} I.R.C. §§ 54AA
\item \textsuperscript{159} Ang, et. al. \textit{supra} note 123 at 73 n. 4.
\item \textsuperscript{160} Julie Creswell, \textit{Stimulus Bond Program Has Unforeseen Costs}, N.Y. TIMES (June 15, 2008) at B1.
\end{itemize}
The origination fees costs though rapidly fell, toward the asymptote of the muni tax-exempt bond fees. Part of the reason, of course, is that during the initial phase, underwriters had less familiarity and thus had to charge more for such uncertainty, and they likely also had some start-up costs too.

Additionally, under the current statutory structure, there is a limitation of the amount of proceeds that may be used for the bond issuance costs, including both underwriting fees and insurance costs. Under the statute, if the issue price has more than a de minimis amount over the stated principle amount of the bond, it does not qualify as a BAB. A de minimis amount is determined by I.R.C. § 1273(a)(3). Under that section, the de minimis amount is determined by the ¼ of 1 percent rule. Thus if the issue price minus the stated principle amount of the

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161 Id.
163 Id. at 9-10.
164 Id.
165 Id.
166 Id. at 11.
168 Id.
169 I.R.C. § 1273(a)(3).
bond is greater than \( \frac{1}{4} \) of 1 percent of the stated issue price at maturity multiplied by the number of years to maturity, it is not valid.\textsuperscript{170} Thus this helps keep these extra fees in check.

Finally and most importantly, perspective is necessary in this particular sphere. Even the critical New York Times pieces and others have shown a convergence of underwriting fees to that of tax-exempt bonds,\textsuperscript{171} while the program, has produced a 80-90 basis point savings in interest with the 35% subsidy.\textsuperscript{172} Even if the subsidy were reduced to 28% of interest, that is still a 40-50 basis point reduction when compared at the longer tail to tax-exempt bonds according to calculations above.\textsuperscript{173} These savings accrue every year, and likely will outweigh the issuing fees. Thus, that makes the underwriting fees controversy seem small.

Overall, the underwriting fees issue is rather small, and likely something that seems to work itself out over time. Indeed, one of the worst things to do is to allow BABs to disappear from the market for an extend period of time before reauthorizing and making the program permanent, as the banks will lose the capacity that they need to serve as proper intermediaries.

B. Offset Concerns

One of the other major concerns for states and localities concerns offset of the tax refund payment to satisfy a debt, either tax or nontax, owed to the federal government.\textsuperscript{174} It is a real problem as subnational governments lose the part or all of the subsidy payment because they owe a debt to the federal government. In turn this effect has diminished some states’ support of

\textsuperscript{170} I.R.C. §§ 54AA(d)(2)(C), 1273(a)(3).
\textsuperscript{171} Creswell supra note 160.
\textsuperscript{172} Treasury BAB Report 2011 supra note 110 at 10.
\textsuperscript{173} The calculation is based on the graph and information in Part IV.B.2.
\textsuperscript{174} Creswell supra note 160.
the program, as they may not ever see their subsidies. Offset is not a problem for tax-exempt bonds, because there is no actual subsidy paid, i.e. in offset parlance there is no payment. The subsidy is the lower interest rate that results from the tax-exemption.

The concept of offset is that it is ridiculous for A to pay B when B owes A money. Over time, the federal government has used this concept established originally by case law to recoup debts, and it has even codified it in certain parts of the law. Offset can only apply to an actual payment of money and property. It cannot apply to a phantom payment that causes a lower interest rate, like a tax expenditure.

Such an offset though would substantially change the nature of the subsidy, and makes BABs less attractive when compared to the current structure of tax-exempt muni bonds. But there is a way around tax levies and centralized offset for federal nontax debt.

To preserve states getting the full amount of these payments regardless of debt or outstanding federal taxes, Congress can easily amend statues to provide for technical fixes. On the nontax debt side this statute is at 31 U.S.C. § 3720A. For tax levies the statutes are I.R.C. §§ 6331(h), 6334. All Congress has to do is add a section that protects BAB payments from offset and tax levies.

Protecting payments from offset is not unusual at all. Under 31 U.S.C. § 3716(c)(3) certain classes of payments are either entirely protected from administrative offset or the amount

175 Id.
that the federal government can offset is limited.\textsuperscript{178} On the tax levy side, I.R.C. § 6334(a) provides a list of payments that the federal government may not levy to satisfy a tax debt.\textsuperscript{179} Hence, providing for a limitation is well within Congress’s power.

The effect of providing such protection is that it would eliminate a major hurdle that gives states and localities pause when selecting BABs over tax-exempt bonds. Particularly if the goal is to shift from tax-exempt bonds as the mean for financing subnational borrowing toward the BAB model as it is more effective, making this change would ensure support for states and localities of this move. Any proposal to renew BABs and move toward them then should include protection of the payments from both administrative offset for nontax federal debts as well as from federal tax levies.

VI. The Problem of Politics

While BABs do have some problems that are easily solved, the goal of phasing out and replacing tax-exempt bonds with BABs is fraught with greater political problems. Even with BABs merely serving as a supplement to tax-exempt bonds, they have disappeared, which is on the end even less disruptive than full replacement.\textsuperscript{180} Plans to reauthorize and make BABs permanent have stalled even though the Obama White House continues to request a permanent and expanded program.\textsuperscript{181}

This section seeks to highlight what are some of the pitfalls the program faces politically on a larger scale. It is not exhaustive. But it does seek to provide multiple perspectives, based on work in political science, as to why BABs face such a political challenge in replacing the current

\textsuperscript{178} 31 U.S.C. § 3716(c)(3).
\textsuperscript{179} I.R.C. § 6334(a).
\textsuperscript{180} I.R.C. § 54AA (stating date of issue must be before Jan. 1, 2011).
\textsuperscript{181} Creswell \textit{supra} note 160, GREEN BOOK \textit{supra} note 110 at 11-12.
structure of tax-exempt bonds. The goal of highlighting these matters is to make those who advocate for better policies and indeed broader tax expenditure reform, even if one seeks to replace it with an alternative subsidy, of the political problems and challenges. In particular to BABs, it hopefully provides insight to what barriers stand in the way of this adaptive change, and the type of leadership as well as opportunities are required to make that change. While extensive, it does not contend to hold every possible barrier up for scrutiny or propose a full map through the wilderness.

This section will begin with a few complementary political science theoretical frames. They are the politics of regulation and visibility, the latter of which is subdivided into two sub-frames of policy-participation feedback loops and the submerged state. It will then move from these to three conditions that further exacerbate the problems shown by these theoretical frames: partisanship, the crimped debate and issues in our taxing and spending dialogue, and regionalism in the BAB context. Finally, it briefly discusses a way forward via fundamental tax reform and the need for good entrepreneurial policy leadership in Congress.

A. The Politics of Regulation

In his famous essay, the late James Q. Wilson discusses what he calls the politics of regulation.182 Wilson divides the world of legislation and regulation into four areas. They are: (1) diffused benefits and diffused costs, (2) concentrated benefits and diffused costs, (3) concentrated benefits and concentrated costs, and (4) diffused benefits and concentrated costs.183

183 Id. at 86-89.
A move to replace tax-exempt bond with BABs falls in the last category. The beneficiaries of the move to BABs are most taxpayers at all levels of government. With increased revenue and efficiency federal dollars go further and states get fuller subsidy. But the costs are highly concentrated. In particular high marginal rate taxpayers would lose greatly, as they would no longer have a tax-preferred investment option that is better than all taxable options.184

Such a policy shift though is generally thought of as unlikely under political science matters, barring a major systemic shock.185 This conclusion stems from the fact that the large group is likely unorganized and the benefit is often delayed and contingent, whereas there will be immediate and large harms on a small group of people who can easily organize.186 That said, many of the key regulatory legislation happened in the 1960s and 1970s fit this description.

Wilson’s solution to this puzzle is entrepreneurial leadership in Congress.187 Particular members would champion such a bill, and coordinate with other political actors and the media to raise the profile of the issue, like in auto safety or environmental regulation.188 Generally, in order for such legislation to develop, such an entrepreneurial member must focus on some sort of “evil” currently in the system, like a certain corporation or industry.189 This act leads toward an initial strong regulatory response and ends eventually in a piece of legislation shaped by bargains made along the way.190

184 See Ang et. al. supra note 123 at 72 (stating that it is no longer optimal for high marginal rate taxpayers to invest in BABs).
185 Wilson supra note 182 at 87-88.
186 Id.
187 Id. at 88.
188 Id. at 88-89.
189 Id. at 89.
190 Id.
In this particular instance there may be some glimmer of hope in that there is growing tension between rich and poor in the U.S. in 2012. Such a means provides an exploitable “evil” in Wilson’s analytic frame. The question though arises as to whether or not a Member of Congress can capitalize on this tension to exploit it for gain politically.

Unfortunately, in the case of tax-exempt munis and BABs, entrepreneurial membership is lacking. As shown below, visibility and the submerged state, the growth of partisan politics, and even regionalism limits the chance that entrepreneurial leadership will arise. While it is a key part of the President’s agenda, unless it is part of a larger tax reform and deficit reduction package, it is unlikely to be politically worth his time. Someone in Congress thus must champion a very odd and complicated program.

Also, the complexity of trying to explain the favorable treatment of the rich with tax-exempt bonds and how BABs are better is difficult. As even this paper and its existence itself shows, such a policy, unlike environmental regulation or consumer safety, is difficult for the public to grasp. A Member is unlikely then to make a name for himself through some sort of a hearing like the consumer safety or seatbelt people did. In many ways, these other events have a greater salience, as once publicized in a hearing they are more easily available than some heady tax expenditure.

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192 Wilson surpa note 182 at 89.
193 See Part III supra, which shows how complicated even explaining the problems with tax-exempt bonds can be.
194 Id. at 89.
195 See generally Kahneman supra note 49 at 129-36 (describing the strength of availability heuristic regarding dramatic events, personal experience, and ease of bringing to mind a similar event).
Thus, for a successful move to BABs, a Member of Congress must step out to provide real leadership, but that is unlikely to arise for numerous reasons. This threatens good policymaking and hinders the ability to change this key part of infrastructure financing.

B. Visibility

BABs also present a problem on the dimension of visibility. This useful analytic tool comes from the idea of participation-policy feedback loops and the submerged state, and they extend and refine the Wilson analysis discussed previously. Both tell a similar story as to why replacing the muni bond exemption with BABs creates such a difficult problem. This section will first outline the two frameworks, with a goal to show how they overlap, and then apply them to this particular problem.

1. Participation-Policy Feedbacks

Andrea Campbell’s seminal work has outlined that not only do certain well-connected groups get more out of the government, but also that policies themselves can affect groups’ participation in democracy. Campbell’s generative case for her ideas arises from the study of senior citizens and Social Security.

Social Security ties seniors directly to the state through a check, and the policies themselves even create a new set of self-interests. It is incredibly visible as a policy. Furthermore, the ideas around the program are that it is earned, and that defending it is a proper

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196 CAMPBELL supra note 69 at 2.
197 Id. at 7.
prerogative.\textsuperscript{198} Thus, it encourages through this participation through letter writing campaigns and the like.\textsuperscript{199}

Social Security is also unusual in that it provides a counter example to the story that high-income individuals participate disproportionately within the political system.\textsuperscript{200} Indeed, it is often found that lower-income senior citizens participate more frequently.\textsuperscript{201} They learn both important senses of civic worth and participation from their higher income compatriots.\textsuperscript{202} They also stand to lose much more with cutbacks in the program.\textsuperscript{203}

In the world of Wilson’s diffused benefits, concentrated costs then, building a constituency through a feedback loop helps break the cartel effect that Wilson posits in his writing. Visibility and identifying a broad group that is connected to a policy by both providing some level of economic support and messages of civic virtue in protecting it is key. Yet, such an attempt may fail when it runs as a reform to the problems of the submerged state.

2. The Submerged State

The idea of the submerged state is almost the counter-story to Campbell’s. Unlike the visible Social Security, the submerged state are a set of policies like hidden subsidies or payments to households that are either not salient, or delivered through a non-governmental intermediary.\textsuperscript{204} Many of these polices came up by accident, but they grew and the accidental

\textsuperscript{198} Id. at 6.
\textsuperscript{199} Id. at 7.
\textsuperscript{200} Id. at 6-7.
\textsuperscript{201} Id.
\textsuperscript{202} Id.
\textsuperscript{203} Id.
\textsuperscript{204} METTLER \textit{supra} note 88 at 4.
ones found support from a growing set of conservative policymakers. Some examples of the submerged state are: subsidized student loans, whereby the federal government pays private companies to loan money to students; the employer sponsored insurance exemption, where employer provided health insurance is exempted from taxation; the home mortgage interest deduction; and retirement savings benefits. In each of these programs, the government’s role is hidden away from the view of the public.

The submerged state’s tools, like tax expenditures, are particularly appealing to both political ends of the spectrum for different purposes. Using the submerged state allowed the right to deter government spending by “starving the beast” while helping out certain favored constituencies. Additionally, Democrats went along with it was a way to get some of their agenda through Congress and its multiple veto points.

The submerged state is also highly pernicious particularly in dimensions (2) and (4) of Wilson’s framework. This is because of two reasons. First, interest groups are often energized. Not only did they organize in a way Wilson predicted, but also in Mettler’s research, they extended their reach through massive flows of political money. Furthermore, these organizations do not limit their money to one side. During the period of the Republican K-Street Project in the late 1990s and early 2000s, whereby the Republican Party sought to create a

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205 Id. at 15-16.
206 Id. at 9-12.
207 Id. at 17-18.
208 See id. at 18-19 (discussing how Democrats developed a taste for tax expenditures and how they are much easier to pass into law given the fact that they face fewer veto points).
209 See generally id. at 32-35 (stating that industry organizations soon coalesced around submerged state policies and gave a great deal of money to these actors).
210 Id. at 33-35.
permanent majority and coerce these organizations to give only to Republican causes, industries still crossed the aisle.\textsuperscript{211}

Second, it is pernicious in these dimensions, because the larger mass of citizenry does not even know of these programs.\textsuperscript{212} This hinders the ability to form well-informed opinions that are necessary for democratic functioning and policy debates.\textsuperscript{213} Furthermore, with these submerged state dimensions, citizenry do not see themselves as benefitting from them and thus it engenders a negative view as to whether the government helps them out in their lives.\textsuperscript{214} These all combine toward a stronger sense of demotivation toward political action than Wilson says when the diffused costs or benefits are invisible.\textsuperscript{215}

Thus, the submerged state prevents Campbell’s virtuous policy cycle from coming into place and gives greater strength toward those concentrated interests supporting the status quo. This presents some major problems for replacing tax-exempt bonds with BABs.

3. BABs, Tax-Exempt Muni Bonds, and Visibility

The goal of switching over from tax-exempt interest payments to BABs is incredibly problematic given both of these theories. It seeks to take an invisible policy and replace it with a visible one, which is good for democracy, but bad for politics. And it does this with little cover for politicians making the change, as it does not institute a feedback loop that creates constituencies that benefit and feel a desire to participate.

\textsuperscript{211} Id. at 35-36.
\textsuperscript{212} See generally id. at 37-40 (data revealing that most beneficiaries of submerged state transfer programs do not recognize it as a government program).
\textsuperscript{213} Id. at 26-27.
\textsuperscript{214} Id. at 42-43.
\textsuperscript{215} Id. at 45-46.
First, the switch to BABs does not have any of the positive feedback loops that Campbell states. The key benefits, while more direct than they are in the tax-exempt bond situation are still quite attenuated. BABs deliver their benefit mainly in two ways to the populace: through effective capital project financing, which leads towards critical infrastructure, and through an ability for subnational governmental units to keep their taxes low. Both of these benefits are discussed above, but are quite complicated. They are a far cry from getting a check in the mail from the Social Security Agency. Thus, even the more visible policy likely will not be able to create a constituency that gets people excited, save the very wonky like the author.

Second, BABs seek to impose costs on a set of well-organized and active groups. One group is higher-income individuals. As stated earlier, they tend to participate more frequently in politics both because they have the means and the desire. In this particular case they would lose a tax-favored saving mechanism if BABs became the ways for subnational governments to finance debt. In an odd way, eliminating this tax-expenditure will likely make them particularly angry, because many, even though they use a lot of tax-expenditures including this one to shelter income, see themselves as paying too much in taxes. Furthermore, this group has something that is key for exerting their influence, and that is the means of not only money to survive, but also money to give to politicians through various means.

Another key group that would also likely fight the elimination of tax-exempt bonds, even when replaced with BABs, is the financial industry. While supportive of BABs they want both products to survive in their current form. As Michael Decker, head of the Securities Industry

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216 CAMPBELL supra note 69 at 6.
217 Ang et. al. supra note 123 at 71.
218 METTLER supra note 88 at 43-44.
219 Id. at 33-35.
220 Decker supra note 56.
and Financial Markets Association (SIFMA), which represents securities firms, banks, and asset management companies, states in his opinion piece supporting BABs, they should not be seen as a replacement for tax-exempt bonds.\textsuperscript{221} Such a move would eliminate a product line, and if they encourage tighter controls on subnational governmental unit borrowing, as BABs currently do vis-à-vis tax-exempt munis, they will likely reduce their income. This group too, serves as a well-organized interest that would then effectively mobilize against the elimination of the submerged state.\textsuperscript{222}

Third, the type of visibility, as discussed in the sections below, is particularly problematic. By switching to a direct expenditure, it appears as if the federal government is expanding, even though it may actually be shrinking.\textsuperscript{223} This point will rile conservatives.\textsuperscript{224} The visibility will also reveal what states and localities utilize such a subsidy in a more real way, and that can lead to regional problems, as discussed below.\textsuperscript{225} These types of visibilities in the BAB program then open it up for attack, whereas they shield the tax-exempt bond program from these critiques.

In trying to break through these problems, Mettler herself offers a possible pathway to reform.\textsuperscript{226} But in this particular case a lot of them are inapplicable, like reconfiguring vested interests\textsuperscript{227} or making it more visible,\textsuperscript{228} because of the complicated nature of infrastructure financing, which differs from welfare policies. That said, it is important to have effective

\begin{itemize}
\item \textsuperscript{221} \textit{Id.}
\item \textsuperscript{222} Mettler supra note 88 at 33-34 (finding the extraordinary lobbying dollars the financial sector puts into the submerged state and how it is related to the benefits they receive in administering these programs).
\item \textsuperscript{223} Part VI.D. infra and Part II.B. supra.
\item \textsuperscript{224} Mettler supra note 88 at 17-18.
\item \textsuperscript{225} Part VI.E. infra.
\item \textsuperscript{226} See generally Mettler supra note 88 at 114-121(providing a rubric for policy development and ideas for policy implementation).
\item \textsuperscript{227} \textit{Id.} at 114.
\item \textsuperscript{228} \textit{Id.} at 117.
\end{itemize}
political communication from leaders trying to push the policy. This could be the President, who could make a stronger push for BABs to replace muni bonds, and it also requires a strong policy entrepreneur in Congress, once again, echoing Wilson’s views. Additionally states and localities can make the savings in interest through the BAB subsidy more apparent to taxpayers by perhaps including that information in the tax bill as to how it keeps their tax rates lower. Finally, it is vital and perhaps most important for states and localities as well as civic society organizations to support and publicize the use of BABs, even under the existing program, as opposed to normal municipal financing, so the public becomes more aware. It is incumbent for states and localities to become vocal supporters of the BAB program, since they are the most direct beneficiaries of its largess.

But, this path forward is fraught with other problems. The next sections reveal problems of the partisan nature of BABs themselves, the use or misuse of tax-expenditures for political gain, and the regional complications that BABs raise and tax-exempt munis do not.

C. Partisan Polarization and Politics

Perhaps one of the most important stories is the rise, or rather return, of partisan politics in the U.S. Congress; this polarization has a major effect on BABs and any other tax expenditure reform. In particular BABs see this partisan effect even more acutely, because of their connection to ARRA, i.e. the stimulus. Republican opposition to this reform runs high.
The rise of polarization is well documented in both anecdotal and quantitative accounts. Anecdotally, long-term Congress watchers have seen a shift in the two parties' makeup, towards more homogenized and polarized identities.\textsuperscript{233} Some of the sources of this shift are: the decline of Southern Democrats and the New Deal coalition, the disappearance of Northeastern Republicans, geographic ideological sorting, partisan redistricting, Vietnam, the pro-life movement, the new conservatism, and the growing number of Senators who served previously in the House as some sources that engendered such growing partisanship.\textsuperscript{234} Additionally, Congress itself has seen levels of a loss of institutional cohesiveness.\textsuperscript{235} It used to be said in the House that the other party was just the opposition, while the enemy was actually the Senate.\textsuperscript{236} Now though, partisan identification takes hold and the institutions that people once took pride in are despised by the members themselves.\textsuperscript{237} Observers and historians do point out that this rise in partisan polarization is something that did exist in Congress throughout the 19\textsuperscript{th} and early 20\textsuperscript{th} Centuries, but is unusual for the post-war era.\textsuperscript{238} As a result partisan identification is higher, and many high-profile issues are linked towards party identification.

Greater polarization is also supported in more quantitative studies. Recent empirical work has challenged the idea that members of the House are driven primarily by district and local

\textsuperscript{233} \textsc{Thomas E. Mann \& Norman J. Ornstein}, \textit{The Broken Branch: How Congress is Failing America and How to Get it Back on Track} 11-12.
\textsuperscript{234} \textit{Id.} at 11-12, 224-25
\textsuperscript{235} \textit{Id.} at 146-49.
\textsuperscript{237} MANN \& ORNSTEIN \textit{supra} note 233 at 148. They cite that Members of the House and Senate no longer move to Washington permanently and thus, the ability to interact as a community declines.
\textsuperscript{238} \textit{Id.} at 10-11.
politics and instead are far more partisan.\textsuperscript{239} Indeed, for most of the time partisan polarization was the norm, but during the middle 20\textsuperscript{th} Century, there was a significant decline towards district responsiveness.\textsuperscript{240} Additionally, scholars have found that party influence in Congress has grown.\textsuperscript{241} Party influence was originally high in the traditional eras of polarization before WWII, but after a lull in the post-war period, it started to rise again in the 1980s and 1990s.\textsuperscript{242} High levels of partisan influence appear in the areas of close votes.\textsuperscript{243} Party priority legislation also sees greater partisan influence.\textsuperscript{244} Finally, issues like taxation and other economic policy issues exhibit very high party influence on legislators.\textsuperscript{245} Thus, the empirical data shows that partisanship can be an important matter.

In general this partisan polarization spells particularly bad news for both BABs as an alternative to tax-exempt bonds, and larger rethinking of tax expenditures in our policy discussion. First, these issues are fundamentally tax, federal budgetary, and economic issues. As stated by the research in empirical political science, this is the area where the partisan divide is greatest and where parties have always exerted the greatest influence.\textsuperscript{246} Thus, this particular change will have to overcome the polarization that attaches to that issue.\textsuperscript{247}

\textsuperscript{240} Id. at 137.
\textsuperscript{242} Id.
\textsuperscript{243} Id. at 198-99.
\textsuperscript{244} Id. at 201.
\textsuperscript{245} Id. at 202-03.
\textsuperscript{247} Many would, of course, contend that the Tax Reform Act of 1986 serves as a symbol of possibility here. But, as accounts have shown its path was tortured and done over many years. \textit{See generally Jeffrey H. Birnbaum & Alan S. Murray, Showdown at Gucci Gulch: Lawmakers, Lobbyists, and the Unlikely Triumph of Tax Reform} (1987) (the book is the
Second, this is an issue is at least linked towards policies that the two parties have staked out significantly different positions and see as a priority. That issue is the law that created BABs, ARRA. The law itself passed without any Republican votes. Republicans have repeatedly stated as a high-profile issue their opposition to both additional stimulus measures overall, increased tax revenues, and BABs specifically. Furthermore, BABs have been tied to the bailouts of banks and other matters by the Republicans’ language. They have called it a bailout of the states.

Finally, many Republicans nationally see the defeat of the Democratic President Obama as perhaps one of their top political priorities. It is the only way to end what they see as his dangerous policies of wasteful spending and bailouts. This has thus caused them to become even more intransigent and partisan on issues linked towards Obama initiatives like ARRA.

One possible way around the partisanship may come from the state levels who could push for renewing BABs and even replacing tax-exempt bonds with them as the method of financing their borrowing. Republican governors issued a great deal of BABs. They issued about 39% of

definitive account of from journalists of the story of the Tax Reform Act of 1986). It definitely was not easy to overcome some of the partisanship then, and if it has increased it may decrease the chances for meaningful reform.

Jackie Calmes, House Passes Stimulus with No Republican Votes, N.Y. TIMES (Jan. 29, 2009) at A1.

See Jackie Calmes, Obama to Press Committee on Jobs, N.Y. TIMES (Aug. 17, 2011) at A13 (stating that Republicans oppose any additional stimulus and increased tax revenues calling the former not helpful and wasteful and the latter as job killing); Andrew Ackerman, GOP to Block Renewal of Build America Bond Program, WALL ST. J. (Feb. 13, 2011) (stating that the program was a state bailout program and costs far more than it would recoup in revenue gain).

Ackerman supra note 249.

Manu Raju, McConnell Doubles Down on Obama, POLITICO (Nov. 3, 2010).

Id.

Id.

the number of bond issuances and about 53% of the total dollar value of bonds issued.\textsuperscript{255} That said, few governors across the aisle and others have supported BABs publicly and that limits the hope to overcome partisanship. Without this kind of support though and building such a coalition that crosses party lines from those who benefit from BABs, they will just die, and the hope for a more effective replacement for tax-exempt muni bonds will disappear.

D. The Politics of Taxes and Spending: Misunderstanding Tax Expenditures

Another major political hurdle arises from the fact that the concepts of tax expenditures themselves are quite squishy and complicated. As stated above, individuals like Justice Anthony Kennedy and Grover Norquist consistently discuss tax-expenditures as a positive.\textsuperscript{256} They also have a serious problem too when the same policy switches over from a tax-expenditure to a direct spending program. Unfortunately, if one wants to preserve a way for states to finance such borrowing at reduced rates, these are the only two options. One could eliminate all forms of subsidy, but that presents its own sets of problems, as discussed above in Part III.F.

Given the sort of anti-tax, small government rhetoric of people like Mr. Norquist and his numerous signers of the pledge signatories in Congress, the move toward BABs as a replacement for tax-exempt bonds, however more efficient on budgetary grounds, seems unlikely to get their support. After all, when your rhetoric is smaller government, it makes little sense to take switch to a situation with higher outlays and revenues from the current state.\textsuperscript{257}

\textsuperscript{255} Id. at Appendix, National Totals.
\textsuperscript{256} Part II.B supra.
\textsuperscript{257} See C. Eugene Steuerle, Contemporary U.S. Tax Policy, 247 (2008, 2d ed.) (stating that tax expenditure subsidies are politically more appealing, because they create smaller government with lower taxes and outlays).
Currently, anti-tax, smaller federal government spending rhetoric runs particularly high within certain conservative groups, like the Tea Party. Also given their dislike of the financial sector, such a policy like BABs, which benefits that sector as well are unlikely to gain much traction. But, they do not disagree with keeping tax-exempt bonds. The fundamental misunderstanding is something quite hard to dispel, because, as this paper has shown, it is itself difficult to explain the ins and outs of tax expenditures generally and the interest exemption for muni bonds particularly. Indeed, even if one understands, the fact that both income and expenditures increase implies a perception of growing government, even if in reality it is not. As with many issues in politics, perception is not separate from reality; it is reality.

Unfortunately trying to change minds here is difficult. Given our desires to self-deceive to justify cognitive dissonance to show we were right all along combined with confirmation bias, people, particularly those in the public arena who have taken such a strong, especially illogical stand are unlikely to change their views. Ways forward here may require the electorate to change some of the personnel, but recent stories have shown the same sort of conflict in taxing and spending may even seep down to the electorate.

Once again, perhaps some grand bargain could cut through. Even strongly anti-tax allies of Mr. Norquist, like Senator Coburn, seem to recognize that there may be a problem here,

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258 Part III. supra.
259 See KAHNEMAN supra note 49 at 80 (describing confirmation bias, whereby one seeks out information to prove one’s prior position, and discounts any contradictory evidence). See also generally CAROL TAVRIS & ELLIOT ARONSON, MISTAKES WERE MADE (BUT NOT BY ME): WHY WE JUSTIFY FOOLISH BELIEFS, BAD DECISIONS, AND HURTFUL ACTS 19-32 (2007) (describing cognitive dissonance, a theory where when confronted by facts that undermine well-held beliefs, especially those that pertain to self-characteristics, people apply things like confirmation bias to reduce the tension between these facts and their sense of self and beliefs).
especially if we wish to fix our fiscal house.\textsuperscript{261} Additionally, as shown later, tax reform could cause a reanalysis of support for tax expenditures as a means of providing a subsidy. For example, if replacing tax-exempt bonds with BABs allows the federal government to actually save money in providing the same level of subsidy,\textsuperscript{262} those gains can be used to offset losses of other parties by lowering rates generally. Still such a move, however necessary, may be limited in this area given the rhetoric that has developed.

Yet even in this context, solutions will likely require the mobilization of a diverse group of people. Subnational governments clearly need to provide support. Another necessary factor is getting a Member of Congress to champion BABs within a larger tax reform package. Perhaps some of the OWS-minded individuals who are against these tax breaks could provide support. But, given the hold Mr. Norquist over a large number of Members of Congress, such an effort will be difficult and require great coordination.

E. Regional Politics

BABs also appear to favor urban areas at the expense of rural areas, and that creates another political problem that could defeat them. As Senator Charles Grassley said, the program would, in his opinion, be better named as the “‘Build California and New York Bonds Program.”\textsuperscript{263} Of course, California and New York are among of the two most populous states with major economic activity and urban centers, and along with Texas, which also has a large population and is an economic powerhouse with major metropolitan areas, serve as the lion’s

\textsuperscript{261} Munger \textit{supra} note 23.
\textsuperscript{262} Parts III.B.1. and IV.B.I.
\textsuperscript{263} Creswell \textit{supra} note 160.
share of issuing BABs.\textsuperscript{264} That is because infrastructure is most dense where there are large numbers of people and a great deal of economic activity.

Unfortunately for BABs, unlike the hidden world of subsidies through the tax-exemption of interest income, the flows of money from the federal center to these urban populous areas and away from rural states with little economic activity is blatantly apparent. Thus, another interest, which really is a small part of the population, arises within the two analytic frameworks of the politics of regulation and visibility theory arises, the rural areas.

Rural areas though are overrepresented, particularly in the United States Senate, which apportions its members by states and not population like the House.\textsuperscript{265} All else being equal, this generally results in an over-allocation of resources to smaller, less populous, rural states.\textsuperscript{266} A recent example of how this effect arises is in Homeland Security grants, which are not apportioned by risk, which would lead toward greater flows into urban areas, but had a way to allow rural states to get more than their risk-adjusted share.\textsuperscript{267}

Furthermore, the procedures and other institutional features of the Senate itself increases this problem of overrepresented rural states. First, there are more overrepresented states than

\begin{footnotesize}
\begin{enumerate}
\item BAB Website.
\item See, e.g., Frances E. Lee, \textit{Representation and Public Policy: The Consequences of Senate Apportionment for the Geographic Distribution of Federal Funds}, 60 J. of Pol 34, 37-38 Table 1 (1998) (showing the ratio of state populations to 1/50 of the national population in 1990 and showing that there are far more overrepresented states in the Senate than underrepresented or even approximately represented).
\item Congressional Research Service, RL34181, \textit{Distribution of Homeland Security Grants in FY2007 and P.L. 110-53, Implementing Recommendations of the 9/11 Commission Act 10-11} (2008) (stating that the 9/11 Commission stated that Homeland Security Grants should all be based on risk assessments, and that while Congress did make changes to reduce the guaranteed amount to every state in certain grant programs it did not move toward an entirely risk-based approach),
\end{enumerate}
\end{footnotesize}
properly represented or underrepresented states combined.\textsuperscript{268} This allows the overrepresented states to kill legislation that would adversely affect them. Second, since an overrepresented state is smaller in population, it usually takes less money per overrepresented state than to garner support for funding flows than it would to add the support of an underrepresented state in the Senate.\textsuperscript{269} As Francis Lee has shown, for the majority of programs, these structural problems and the overrepresentation of rural states in the Senate leads towards underrepresented states to have a lower per capita amount of federal funds flowing to them than the overrepresented states have.\textsuperscript{270} Furthermore, this result is particularly large in transportation infrastructure projects.\textsuperscript{271}

These results from political science and experience about the Senate present a major obstacle for BABs. They reveal what is probably going on right now, most of the “subsidy” from tax-exempt bonds is flowing to those states that are disproportionately more populous, with large urban centers, and provide major levels of economic activity. BABs move this fact from a hidden nature within the tax code to a plain sight through a direct expenditure, and as Senator Grassley’s comments show, rural areas thus become more aware that they are not getting as much from the federal government. This would lead them to kill then BABs as a replacement mechanism for tax-exempt bonds. Again, while the reality has not shifted, the perception has, and that is what matters politically.

Furthermore, as Lee shows, transportation infrastructure tends to be one of the most malapportioned level of federal funds through the Senate.\textsuperscript{272} This is particularly bad, because first, BABs would replace tax-exempt bonds, which are perhaps the biggest source of financing

\begin{footnotes}
\item[268] Lee \textit{supra} note 265 at 37-38.
\item[269] \textit{Id.} at 40.
\item[270] \textit{Id.} at 49-59.
\item[271] \textit{Id.} at 52, 56.
\item[272] \textit{Id.}
\end{footnotes}
for transportation infrastructure projects. BABs would mean revealing an already large subsidy that flows toward unrepresented states instead of overrepresented states in the Senate. This result gets Senators from small states angry, because they finally see that they are not getting enough of the federal largess in an area where they traditionally thought that they did. This may lead them to either then kill the switch, or do other things to structure it in a way that reduces the efficiency gains, like the Homeland Security Grant programs.

That said, small states all took advantage of BABs during their brief life. Indeed, if one looks at per capita issuance amount, the state of Utah, not one of the most populous states in the Union, actually has the highest amount per capita of BAB issuance at $927.60. Thus, small states can benefit from them, if they have a great deal of valuable and worthwhile capital projects that meet the test. Secondly, small states can indirectly benefit from BABs, because major infrastructure improvements in places like New York, Los Angeles, or Houston allows for goods to flow to them and them to ship their products elsewhere in our increasing globalized society. This indirect benefit, though hard to measure, is likely extraordinarily valuable, and BABs would help bolster this result by preventing the decay of our infrastructure.

Successfully overcoming these doubts though requires policy entrepreneurs who can give the message that too much is at stake to keep the current tax-exempt bond system for infrastructure finance or to eliminate it completely. It requires a compelling message of trying to get people to realize that the United States is one country and that there is a great deal of interdependence. Such a move is not easy. But given the dire warnings too of our crumbling

\[273\text{ See CBO-JCT supra note 5 at 2 (showing that the amount spent on transportation infrastructure financed by tax-preference bonds in 2007 was $126.6 billion).}\]
\[274\text{ BAB Website (showing that all 50 states issued BABs, as well as territories and the District of Columbia).}\]
\[275\text{ Ishimatsu, et. al. supra note 254 at Appendix 1, Utah.}\]
infrastructure\textsuperscript{276} and the concerns about effective federal spending brought forward by people like the Bowles-Simpson commission, it is something this nation needs.

F. Fundamental Tax Reform and Leadership

In light of these problems, the switch from tax expenditure to direct spending in BABs may only be able to arise in fundamental tax reform. Such reform allows political horse-trading. Different groups of winners can trade their gains to help cushion the blow to losers and get their support. As stated earlier too, fundamental tax reform also provides an opportunity for the issue to reach a higher level of national salience that would likely get the White House involved and would give them some reason to devote energy to this seemingly obscure topic, because it is within the broader backdrop of this major reform proposal. But even with expanded options to trade off in fundamental tax reform, entrepreneurial leadership in Congress and elsewhere is necessary to ensure that BABs replace tax-exempt bonds.

Entrepreneurial leadership in Congress is needed to mobilize the factions of rural state leaders, many of whom seem to have used BABs in very high levels and who are Republicans, to voice their support for this method of financing, particularly if the changes in Part V are made. Mobilizing and gaining the support of these factions can provide an important counter narrative to the rhetoric of Senators Grassley and McConnell to show that these benefits cross party lines, are good fiscal policy, and benefit rural areas as well as urban areas. Indeed were the Congressional entrepreneur not only a well-positioned member of these chambers, but also a former governor, who can also speak personally from experience to others in Congress, she

\textsuperscript{276} \textbf{AMERICAN SOCIETY OF CIVIL ENGINEERS} supra note 95 at 2.
would be an almost ideal. She can speak directly to the benefits BABs had on her state through experience and would be positioned to place the issue on the Congressional agenda.

Such a leader should possibly also draw on the current populist swing for additional support to this measure. As stated above, there is a growing perception of those who are well off benefitting greatly from economic gains over the last three decades disproportionately as well as able to play games with areas of the law like the tax code. Someone too who can help focus and make this point salient could stand to garner support from a faction of populists who generally seem less interested in, or disgusted by, matters of finance.

Finally, such leadership is needed, of course, to keep people focused and educated on the matter. While large and important, it is easy for this issue to get lost within larger reform with bigger items like corporate rate reductions. Without agitation and focus, these kinds of major changes do not get made, as the old systems are hard to displace.

Such entrepreneurial leadership then often is one person, but the key is that this one person can mobilize a coalition of people to express each of these various ideas mentioned in this section and also make course changes. It could also, especially within the partisan environment, be a group of more than one person. Yet the struggle is to find such a leader or leadership group within Congress. Such is a rarity in our current political environment. Also, as stated, the Executive does not have the ability to champion such a narrow issue and work on it through a broader reform process. It is thus ultimately within the dysfunctional first branch where our hopes for this type of change must ultimately lie.

VII. Conclusion
BABs serve as another way forward in financing subnational government debt. While this paper assumed that such a subsidy is worthwhile, it has attempted to examine other important aspects of the tax expenditure of exempting interest and comparing them to direct payment BABs. Overall, BABs are more effective at delivery and have great success in allowing us to engage in debates on what is the optimal subsidy rate and what controls are necessary.

That said some changes must be made to the program to have it work more effectively. Many of these are rather easy for Congress to fix, like offset. Others like the bond origination fees are likely to take care of themselves over time, but there could be added help through better program design. That said given that we have run the program before we better understand these implementation problems and can fix them.

Perhaps the bigger problem though is overcoming the huge political resistance BABs have created. Part of that, as political science theory shows us, is to be expected, given the politics of regulation and the fact that we are moving from the invisible and submerged regime of tax expenditures to the brighter daylights of direct spending. Some of that arises from our hyper-partisan atmosphere. Some of that also arises out of regionalism that is enhanced by the lopsided structure of our government. These political problems combined make the shift to BABS extremely difficult.

Though the last section of this paper is discouraging, fundamental tax reform, which has a growing push, may serve as the opportunity. But even that requires leadership that pushes for this change and continues to educate the public. Such a leader needs to overcome very difficult obstacles while navigating the complex issue of tax reform in general.

Beyond the issue of BABs though, the project here highlights our problems when it comes to discussing tax expenditures. The classic tax expenditure analysis stated in Part II only
does two things, equates a targeted tax break to a direct expenditure. It is only an analytical tool. From a policy perspective, the only question it may effectively raise is the question, at a very high level, whether a direct expenditure is a better way of going forward. But, even that question is highly limited by the current state of the analysis.

To be serious about reforming tax expenditures, this paper itself provides a framework for analyzing the expenditure and reform proposals in a deeper way with greater policy bite. It is based on four key questions. First, is the reason for the tax expenditure legitimate? Second, regardless if it is legitimate or not, does it effectively achieve its goal in subsidizing certain activities under not only the traditional three criteria of tax policy: efficiency, equity, and administrability, but does it also reach this goal in a way that is democracy enabling? Third, if one were to change the tax expenditure, how does it interact with other parts of the code and law and policy and is there a better way to get these benefits with fewer distortions? Fourth, what are the political obstacles in the way of reforming this tax expenditure or moving toward a more direct alternative?

This paper addressed, to a great extent questions two through four, while bracketing the first question about the justification for the policy in the first place. The only way to understand tax expenditures as policy analytically is through a structure like this one, applied tax expenditure by tax expenditure. Some tax expenditures may just have no worthwhile policy justification. Others, like the tax-exempt bonds, may have a worthwhile justification, but something more like a direct subsidy, as BABs provide, is superior. Still other tax expenditures, like the EITC, may benefit from certain features of the tax system, like automaticity, and thus call for tweaks within the code rather than another policy. This analysis thus provides a greater level of policy depth.
Unfortunately, that means that we can no longer make blanket statements about the evils or goods of every tax expenditure. Instead, painstaking analysis is required for each and every one of these provisions. It requires not only tax policy experts, but experts in other policy fields to work across disciplines together to come up with the best way of delivering policy. As such, the lift is huge, but the benefits for our government and policy are much improved.

While this paper focuses on and advocates for changing the structure of one tax expenditure, the broader goal then is to begin to engender a larger conversation about tax expenditures generally. The hope too is that the lenses through which we ask these questions not just focus on economics or even just revenue raising, though they definitely must play an important role. It is also important for us though to consider the political obstacles in the way of making these changes and to also consider our deeply held values as a country. We also need to get beyond a simplistic rhetoric where either they are all great ways to reduce taxes and are therefore an unalloyed good or the view that they all disturb an otherwise perfectly efficient tax system of taxing all income from whatever source derived. The truth of the matter likely lies somewhere in the middle, and a careful discussion like the one here, hopefully gets towards that.