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WHO'S GOING TO PICK UP THE TRASH?—USING THE BUILD AMERICA BOND PROGRAM TO HELP STATE AND LOCAL GOVERNMENTS' CASH DEFICITS

Randle B. Pollard[*]

I. INTRODUCTION

All over the United States, state and local governments are facing increasing revenue deficits due to the recession.[1] Even during good economic times, state and local governments experience temporary cash flow deficits.[2] It is not uncommon that during the fiscal year of a state or local government, there may be a period of time where expenditures exceed the amount of revenue collected.[3] These cash flow deficits are a systemic part of the many state and local governments' fiscal processes where there is a mismatch between the receipt of taxes or other revenues against ongoing expenditures. For example, governmental units typically collect personal income taxes in April, which provides for a natural mismatch of revenue and expenditures.[4] Conversely, state and local governments prepare annual or biannual budgets

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1. *See* Jason Dickerson, *2009–10 Budget Analysis Series: California's Cash Flow Crisis*, LEGISLATIVE ANALYST'S OFFICE (Jan. 14, 2009), http://www.lao.ca.gov/2009/stadm/cash_flow/cash_flow_011409.aspx (describing California's cash flow in a typical fiscal year quarter-by-quarter trend of General Fund receipts and disbursements during the 2007–08 fiscal year, which began on July 1, 2007, and ended on June 30, 2008, and showing that the state receives two-thirds of its revenue in the first five months of the fiscal year but has already incurred over 80% of its expenditures for the same time period).

2. *See* discussion *infra* Part IV.B.

3. *See* Dickerson, *supra* note 1 (describing California's cash flow in a typical fiscal year and demonstrating the cash flow irregularities and short term deficits that result from the mismatch between timing of receipt of revenue and the incurring of expenditures in 2007–2008).

4. *See id.* (showing a surge in revenue California received at the time of the personal income tax filing deadline of April 15 in fiscal year 2007–2008).

based on the projected revenues to be collected and the projected expenditures for that particular time period.[5] However, unexpected reductions in revenues or unexpected expenditures or increases in expenditures will likely create temporary cash flow deficits. For instance, a state may have a substantial decrease in income tax revenue due to high unemployment, which creates a cash management problem.[6] For a local government entity such as a county, municipality, or township, a simple event such as a winter with extraordinary snowfall will cause a local government entity to spend more than what was budgeted for snow removal for that time period. Unless this extra expenditure is accompanied with an increase in revenue, a cash flow deficit may occur later during the local government's fiscal year.

To address temporary cash flow deficits caused by irregular collection of revenue, increases in projected expenditures, and decreases in revenue collection due to an economic recession, many state and local governments issue short-term debt (generally referred to as municipal bonds) to fund their deficits.[7] The use of short-term municipal bond debt to finance temporary cash flow deficits caused by the normal uneven collection of tax revenue typically has been an affordable and reasonable method for state and local governments to fund short-term cash flow deficits when surplus revenue in "rainy day funds" has not been available.[8] However, the subprime mortgage crisis and the recession have substantially increased the cost of issuing short-term municipal bonds, and continue to threaten state and local governments' financial ability to use this tool.[9]

State and local governments throughout the United States have tackled the problem of cash flow shortages by reducing their budgets through cost cutting and expenditure reduction. However, expenditure reduction alone will not solve cash flow shortages. With the economic recession, state and local governments are collecting less revenue and need to be able to issue cost-

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5. The budget process of a state or local government entity is discussed in more detail *infra* Part II.A.

6. *See* ARNOLD SCHWARZENEGGER, GOVERNOR OF CAL., GOVERNOR'S BUDGET SUMMARY 2010–11, at 1 (2010), *available at* http://2010-11.archives.ebudget.ca.gov/pdf/BudgetSummary/Full BudgetSummary.pdf (Governor's proposed budget for 2010–2011 states that there is a projected $6 billion reduction in income tax collected on wages).

7. *See id.* at 9 (noting that the State of California issued $8.8 billion in revenue anticipation notes for the 2009–2010 budget projected cash shortfall).

8. See *infra* Part II.B for examples of state and local governments' use of short-term municipal bonds and a general discussion of the definition and use of rainy day funds.

9. See *infra* Part IV for a full explanation of how the subprime mortgage crisis and the economic recession increased the cost of issuing short-term bonds.

effective short-term debt. Because of the subprime mortgage crisis and the recession, the cost of issuing short-term municipal bonds has increased to a point that some government entities are unable to afford their debt service.[10] Without a reasonable ability to issue short-term debt, state and local governments that have already made budget cuts due to the recession are faced with a severe cash flow problem that threatens their ability to pay for services for their citizens. State governments are faced with difficult cost-cutting decisions such as reduction in state funding of secondary and higher education, reduction in state-provided health care programs, and reduction in the salaries of state employees. Similarly, local governments such as counties, municipalities, and townships are encountering decisions to lay off public safety workers such as firefighters and police officers, reducing library and park hours, or in some cases reducing trash pickup in their communities.[11]

To reduce the issuing costs for state and local government issuers of short-term municipal bonds that are used to finance cash flow deficits due to the disruption to the municipal bond market caused by the subprime mortgage crisis and the recession, the federal subsidized taxable bond program called the Build America Bond program should be amended to apply to noncapital short-term borrowing.[12] As discussed in Part V of this article, the Build America Bond program gives state and local governments an alternative to tax-exempt bonds to finance their capital projects and creates a larger pool of investors willing to purchase state and local government debt.

Part II of this article discusses the use of short-term bonds in the budget process of state and local governments. Next, Part III will provide a general overview of municipal bonds and how state and local governments use bond issuances to provide for their short-term cash flow needs. Part IV provides an analysis of how the subprime mortgage crisis of late 2007 affected the municipal bond market, and gives examples of state and local government cash flow problems due to the economic recession. Part V describes the creation of the Build America Bond program implemented through the American Recovery and Reinvestment Act of 2009 in response to the immobilization of the municipal bond market caused by the subprime mortgage crisis. Finally, Part VI discusses a proposal to provide a more cost-efficient method of issuing debt and borrowing for state and local governments by amending the Build America Bond program to apply to short-term municipal bonds.

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10. *See infra* Part IV.

11. *See infra* Part IV.B.

12. *See* American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 1531, 123 Stat. 155, 358–60; *see also* discussion *infra* Part V.B.

Cash shortfalls can also be caused by fiscally irresponsible behavior of state and local governments. The solution proposed by this article is not to remedy that behavior. The solution proposed is instead meant to address the extraordinary collapse of the municipal bond market in tandem with the economic recession.

II. USE OF SHORT-TERM BONDS BY STATE AND LOCAL GOVERNMENTS

A. Budget Process of a State or Local Government

The general budgetary process is similar among state and local governments. By law, whether by the state constitution or local legislative ordinance or rule, both require the executive branch of government to prepare a proposed budget and the legislative branch to pass legislation to effectuate the budget.[13] Of course, the executive branch for a state is the office of the governor, and examples of the executive branch in local government are a mayor for a city or town, the township trustee for a township; and the county commissioner for a county.[14] Equally, the legislative branch is the state legislature for the state; city or county council for a city or county; and advisory board for a township.[15] The majority of states operate on an annual budget, which provides a budget for one fiscal year.[16] A number of states operate on a biennial budget cycle, which provides a two-year budget.[17] Regardless of whether the budget cycle is annual or biennial, the typical state budget cycle begins with the state budget office sending guidelines on funding requests to state agencies.[18] Each agency submits its funding requests to the governor through the state budget office.[19] The staff of this office reviews the proposed funding requests of each agency and, in some states, holds formal agency budget hearings.[20] In addition to reviewing the agencies' funding

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13. *See* NAT'L ASS'N OF STATE BUDGET OFFICERS, BUDGET PROCESSES IN THE STATES 1–2 (2008), *available at* http://www.nasbo.org/LinkClick.aspx?fileticket=AaAKTnjgucg=&tabid=80.

14. *See Local U.S. Governments*, NAT'L LEAGUE OF CITIES, http://www.nlc.org/build-skills-networks/resources/cities-101/local-u-s--governments (last visited May 17, 2011) (describing the structure of local government).

15. *See id.*

16. NAT'L ASS'N OF STATE BUDGET OFFICERS, *supra* note 13, at 1, 4–8 (Table I, Budget Calendar lists the budget cycles of all fifty states).

17. *Id.*

18. *Id.* at 1–2, 9–12 (describing the budget agency function of all fifty states).

19. *Id.*

20. *Id.*

requests, the budget office is responsible for projecting state revenue.[21] In most states, there is some collaboration between the state budget office and the legislature in preparing projections of revenue.[22] Upon a completed review and analysis of all of the agencies' budget requests and a completed review of the projected revenue, a budget proposal is presented to the governor for approval.[23] The governor's office has an opportunity to make recommendations and changes before approving the proposed budget.[24] After approving the budget, the governor submits the budget for review by the legislature.[25] The legislature has hearings and adopts the budget.[26] The cycle appears to be very simple, but the process can take several months and involve several hearings before a budget is finally adopted.[27] Some states like Illinois and Pennsylvania were not able to adopt a budget at the time of the official adjournment of the legislature due to the disagreement of members of the legislature on what to cut from the state's budget.[28] For example, in 2009 California Governor Arnold Schwarzenegger threatened to force state workers to work an additional unpaid furlough day beginning in July of that year if the Legislature failed to approve his proposed budget that solved the state's $24.3 billion cash shortfall by June 30, 2009.[29] Budgetary impasses on the state level eventually affect local government budgets and local programs.[30]

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21. *Id.* at 1–3, 9–12.

22. *Id.*

23. *Id.* at 2, 29–37 (Table 9 and notes describing the gubernatorial budget authority and responsibility for all fifty states).

24. *Id.* at 2. It is important to remember that the head of the state budget office is typically appointed by the governor. *Id.* at 13. The governor has substantial influence on the proposed budget presented to the legislature. *Id.* at 2, 13.

25. *Id.* at 2.

26. *Id.*

27. *Id.* at 1–2, 40–42 (referring to Table 11 and notes describing balanced budget requirements of all fifty states).

28. *See* Amy Merrick & Conor Dougherty, *Plunging Revenue Squeezes State Budgets Further*, WALL ST. J., July 17, 2009, at A3 (describing the Illinois legislature's budgetary impasse for fiscal year 2009–2010); Amy Worden & Angela Couloumbis, *Pa. Seeks to Avoid Another Budget Impasse*, PHILLY.COM (June 3, 2010), http://articles.philly.com/2010-06-03/news/24962226_1_cigarette-tax-rendell-lower-taxes (describing the Pennsylvania legislature's budgetary impasse for fiscal year 2010–2011).

29. Matthew Yi, *California's Fiscal Crisis: Governor Threatens to Furlough Workers 3rd Day*, S.F. CHRON., June 27, 2009, at B1, *available at* http://articles.sfgate.com/2009-06-27/bay-area/17210634_1_new-taxes-furlough-budget-crisis.

30. *See* Rick Orloy, *State Budget Impasse Keeps Senior Meal Program from Getting Federal Funds*, DAILYNEWS.COM (Aug. 23, 2010), http://www.dailynews.com/news/ci_15870404 (describing possible cuts in state funding to city of Los Angeles for senior meal program); *see also* John Cox, *Child Care Centers Slammed by Economy, Budget Impasse*, BAKERSFIELD (Aug. 29, 2010, 03:40 PM), http://www.bakersfield.com/archive/x464579076/Child-care-centers-slammed-by-economy-budget-impasse

B. Examples of Use of Short-Term Bonds in Fiscal Process

As stated above, revenue is not uniformly collected throughout the fiscal year, which may result in a cash shortfall.[31] The revenues collected by state and local governments can range from taxes such as income, sales, and property taxes, and licensing fees such as business association fees and licensing of motor vehicles.[32] Sometimes revenues collected by state and local governments are not enough to meet current operating expenses.[33] To finance periods of time where expenses are greater than revenue, state and local governments may use surplus funds generated during periods of economic growth and set aside in a "rainy day fund."[34] However, rainy day funds are not always available to fund cash flow deficits due to budget restrictions placed on the fund or simply because there is not a sufficient balance in the fund.[35] To finance periods of time when expenses are greater than revenue and surplus revenue is not available, state and local governments will issue short-term bonds such as tax anticipation notes (TANs), revenue anticipation notes

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(describing possible cuts or delays in State of California funding of local day care facilities due to the legislature's budgetary impasse).

31. *See* CAL. STATE BD. OF EQUALIZATION PUBL'N NO. 29, CALIFORNIA PROPERTY TAX 12 (2009) (installment payments for property taxes are due November 1 and February 1); Ryan Forster & Kail Padgitt, *Where Do State and Local Governments Get Their Tax Revenue?*, 1 (2010), *available at* http://www.taxfoundation.org/files/ff242.pdf (describing property taxes collected in 37 states on the state and local levels, typically collected in two annual installments). Notwithstanding the collecting of property taxes in two installments, taxpayers may also pay their taxes monthly through their mortgage company escrow account.

32. *See* Forster & Padgitt, *supra* note 31, at 1.

33. *See* Tamara Audi, *Cities Rent Police, Janitors to Save Cash*, WALL ST. J., July 19, 2010, http://online.wsj.com/article/SB10001424052748704334604575339153865582376.html (discussing cash shortfalls in cities throughout the United States).

34. Rainy day funds are surplus funds set aside in a state or local government's budget to help when there is a subsequent budget crisis. See David Gamage, *Managing California's Fiscal Roller Coaster*, 49 STATE TAX NOTES 659, 664 (2008) (discussing rainy day funds in general and how increasing the use of the funds stabilizes California's budget crisis); *see also* Brian Knight & Arik Levinson, *Rainy Day Funds and State Government Savings*, 52 NAT'L TAX J. 459 (1999) (examining the effect of rainy day funds on state savings behavior).

35. A detailed discussion of the use of rainy day funds is beyond the scope of this article. *See* Kim Rueben & Carol Rosenberg, *What Are Rainy Day Funds?*, TAX POLICY CTR. (last updated Aug. 12, 2009), http://www.taxpolicycenter.org/briefing-book/state-local/fiscal/rainy-day.cfm (providing a state-by-state analysis of the establishment and funding of rainy day funds and showing that in 2008, forty-seven states and the District of Columbia maintained rainy day funds); *Rainy Day Funds: State Budget Stabilization Funds*, NAT'L CONF. OF STATE LEGIS., http://www.ncsl.org/programs/fiscal/rdfaxa.htm (last updated Mar. 2004) (website requires registration).

(RANs), and bond anticipation notes (BANs).[36] However, as discussed in more detail in Part VI.B of this article, state and local governments are attempting to use short-term bonds to finance cash flow deficits caused by the recent economic recession.

III. GENERAL OVERVIEW OF MUNICIPAL BONDS

Before discussing the problems with the municipal bond market as it relates to short-term bonds, it is important to understand the concept of municipal bonds and why they are important to the financing of government projects and objectives.

A. Federal Tax Exemption of Interest on Municipal Bonds

The general rule regarding interest on state and local government bonds (collectively referred to as municipal bonds) is that such interest is excluded from gross income of individuals and corporations[37] if the proceeds from the bonds are used to finance direct activities of government units.[38] This federal income tax exemption was originally premised on the idea that the federal government should not have power over the borrowing of a state government.[39] The Internal Revenue Code (Code) divides municipal bonds into two categories, governmental bonds[40] and private activity bonds,[41] for tax-exemption purposes. A governmental bond is a bond issued by a state or local entity in which the proceeds are owned and used by the state or local entity.[42] Subject to certain limitations and restrictions, governmental bonds are exempt from federal taxation.[43] A private activity bond is determined by a private business use and a private security or payment test.[44] A private activity bond

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36. See *infra* Part III.C for a general explanation of these types of short-term bonds.

37. The alternative minimum tax imposed by I.R.C. § 55 may subject individuals or corporations to tax on interest received from certain municipal bonds. *Compare* Martin J. Mauro & Philip Fischer, *The Tax Treatment of Municipal Bonds*, *in* THE HANDBOOK OF MUNICIPAL BONDS 581, 581–82 (Sylvan G. Feldstein & Frank J. Fabozzi eds., 2008), *with* I.R.C. §§ 55(b)(2), 57(a)(5)(A).

38. I.R.C. § 103(a).

39. *See* Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, 652 (1895) (holding that states were immune to federal taxation of their borrowing because it was an interference of a state's power to borrow).

40. *See* I.R.C. § 103(a).

41. *Id.* § 141.

42. *See id.* § 103(c)(1).

43. See *infra* notes 67–73 for a discussion of certain restrictions.

44. *See* Treas. Reg. §§ 1.141-2 (private activity bond tests), -3 (private business use), -4 (private security or payment test) (as amended in 2008).

is a bond where more than 10% of the bond proceeds are used by a nongovernmental person in a trade of business, and either more than 10% of the payment on the debt service is derived from a private trade or business or more than 10% of the security for the payment of the bonds is private property.[45] Private activity bonds are not exempt from federal taxation unless they are qualified private activity bonds.[46] Qualified private activity bonds include exempt facility bonds,[47] mortgage revenue bonds,[48] qualified small issue bonds,[49] qualified student loan bonds,[50] and qualified redevelopment bonds.[51] Regardless of whether a municipal bond is governmental or private, it is considered a debt instrument requiring payment of interest to bondholders.[52] With both types of bonds a government unit is the issuer.[53] The municipal bond is considered a debt instrument requiring the issuer of the bonds to make payments of interest to bondholders.[54] There are several types of municipal debt instruments; however, the two most common are general obligation and revenue.[55] These two types of bonds are distinguishable because of the different sources of interest payments to bondholders.[56] For general obligation bonds, the government entity pledges its full faith and credit for the payment of the principal and interest on the bonds.[57] With this pledge, the government entity secures the debt service on the bonds with all the revenue it is capable of generating from its taxing power.[58] Thus, the bondholder can seek repayment on principal and interest from all sources of revenue that the state or local government entity is entitled to receive.[59] The bondholders have

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45. *See* I.R.C. § 141(b).

46. *Compare* I.R.C. § 103(a), (b)(1), *with id.* § 141(a).

47. *Id.* § 142 (discussing those bonds used to finance airports, docks and wharves, mass commuting facilities, water furnishing facilities, sewage facilities, etc.).

48. *Id.* § 143 (discussing those bonds used to finance mortgages for owner-occupied residential property).

49. *Id.* § 144(a) ($1 million or less in bonds used to finance certain manufacturing facilities).

50. *Id.* § 144(b) (bonds used to finance student loans).

51. *Id.* § 144(c) (bonds used to finance redevelopment in designated blighted areas).

52. *See id.* §§ 103(a), 141(a).

53. Treas. Reg. § 1.103-1(a) (as amended in 1972) (referring to "a State, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof").

54. *See* JOEL A. MINTZ ET AL., FUNDAMENTALS OF MUNICIPAL FINANCE 1 (2010); *see also* JUDY WESALO TEMEL, THE FUNDAMENTALS OF MUNICIPAL BONDS 1 (5th ed. 2001).

55. *See* MINTZ ET AL., *supra* note 54, at 2–6.

56. *Id.*

57. *Id.*

58. Richard J. Miller & James A. Coniglio, *The Process and Mechanisms of Funding Public Projects*, *in* STATE AND LOCAL GOVERNMENT DEBT FINANCING § 2:15 (M. David Gelfand ed., 2010).

59. *Id.*

a first claim to the state or local government's unrestricted funds.[60] Typically, general obligation bonds of a local government issuer are secured by ad valorem property taxes and those of a state government issuer are secured by sales and income taxes.[61] The state or local government issuer has a legal duty to pass legislation needed to increase revenues.[62] However, the taxing power of the government issuer may be limited by state constitutional or statutory limits.[63]

Unlike a general obligation bond, a revenue bond is secured by a specific pool or source of revenue.[64] The revenues used to secure the bonds are generated from the activity or project financed by the bonds.[65] For example, a sewer revenue bond is secured by revenue generated from the fees charged by a municipality for the operation of the sewer treatment facility.[66]

In order for a municipal bond to be considered tax-exempt, the Code requires certain restrictions to be met.[67] Interest on municipal bonds is not tax-exempt if the bonds are private activity bonds[68] or arbitrage bonds.[69] In addition, there are requirements for information reporting,[70] bond registration,[71] federal guarantee restrictions,[72] and other restrictions.[73]

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60. Sylvan G. Feldstein & Terry J. Goode, *How to Analyze General Obligation Bonds*, *in* THE HANDBOOK OF MUNICIPAL BONDS, *supra* note 37, at 789, 791.

61. Miller & Coniglio, *supra* note 58, at 22.

62. Feldstein & Goode, *supra* note 60, at 791.

63. Miller & Coniglio, *supra* note 58, §§ 2:15–:16 (providing that though an issuer is pledging its full faith and credit to pay the bonds, it is limited by state constitutional or statutory limits and that the issuer may also be limited by applicable state debt ceilings).

64. TEMEL, *supra* note 54, at 33.

65. Sylvan G. Feldstein, *General Analytical Framework for Assessing the Credit Worthiness of Revenue Bonds*, *in* THE HANDBOOK OF MUNICIPAL BONDS, *supra* note 37, at 809, 809.

66. *See id.* at 995–1003 (discussing the structure, management, issuance, and security of issues involving water and sewer bonds).

67. *See generally* I.R.C. § 103(b).

68. *Id.* §§ 103(b)(1), 141(a).

69. *See id.* § 103(b)(2). An arbitrage bond is a bond whose proceeds are used directly or indirectly to acquire higher yielding investments or to replace funds used directly or indirectly to acquire higher yielding investments. *Id.* § 148(a). The Code disallows tax exemption on arbitrage bonds to limit state and local governments from borrowing money at lower tax-exempt bond rates and investing it in higher interest rate investments. *See id.*

70. *Id.* § 149(e)(1)-(2). An issuer of municipal bonds is required to file a timely report with the Secretary of the Treasury with information regarding the issuance. *Id.* Such information includes name and address of issuer, amount of the issuance, stated interest rate, and term of the bonds. *Id.*

71. *Id.* § 149(a). Municipal bonds offered to the public and with a maturity of more than one year are required to be registered with the Secretary of the Treasury. *Id.*

72. *Id.* § 149(b). No more than 5% of the proceeds of the bond issuance may be guaranteed directly or indirectly, in whole or in part, by the United States or any agency or instrumentality thereof. *Id.*

73. *See* William L. Henn, Jr. & Jeanette M. Bond, *The Basic Rules of Tax-Exempt Financing*, *in*

To finance activities that do not qualify for tax exemption, state and local governments may issue taxable bonds. The overwhelming majority of municipal bond issuances are tax-exempt.[74] Only 2% of the municipal bond issuances in 1989 were taxable.[75] By 2008 that percentage had grown to approximately 26%; in 2009, it was 20%.[76]

Congress has stated that the general principle of tax-exempt municipal bonds is to subsidize state and local projects intended for the good of the general public.[77] The exemption of interest income from federal taxation gives state and local governments a unique financing tool.[78] The tax exemption on the interest paid to purchasers of the municipal bonds reduces the cost of borrowing money for state and local governments.[79] Exempting interest on state and local bonds increases the after-tax yield on the bonds, allowing state and local bond issuers to pay lower interest rates to bondholders.[80] The advantages of tax-exempt bonds are demonstrated in a tax-exempt versus taxable yield equivalence analysis.[81] The tax-exempt interest rate equivalent to a taxable rate is calculated by using a formula that takes into account the taxable rate of an otherwise equivalent security and the marginal rate of an investor.[82] For example, assuming a taxpayer purchases a $10,000 investment, the taxpayer's tax consequences between a tax-exempt bond and a taxable bond are illustrated as follows: A taxpayer who purchases a $10,000 tax-exempt bond that has a yield of 4% receives $400 interest income exempt from

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TAX-EXEMPT FINANCING, at 17, 44–69 (PLI Tax Law & Estate Planning Course Handbook Ser. No. 325, 1992) (providing a complete explanation of the requirements); *see also* I.R.C. §§ 149(f) (regarding restrictions that apply to the issuance of "pooled finance bonds," which are bonds issued as part of an issuance where more than $5 million of proceeds are reasonably expected to be used to finance two or more ultimate borrowers), 149(g) (regarding the restrictions on "hedge bonds").

74. *See* Mark D. Robbins & Bill Simonsen, *Build America Bonds*, 30 MUN. FIN. J., no. 4, 2010, at 53, 55.

75. *Id.*

76. *Id.*; see *infra* Part V for a more detailed discussion of taxable bonds.

77. Jami Eng, *The Tax Reform Act of 1986 and Municipal Bonds: A Study of Three Texas Cities*, at 24 (May 1, 1992) (Tex. State Univ.-San Marcos Applied Research Projects, Working Paper No. 227), *available at* http://ecommons.txstate.edu/cgi/viewcontent.cgi?article=1229&context=arp.

78. DENNIS ZIMMERMAN, THE PRIVATE USE OF TAX-EXEMPT BONDS: CONTROLLING PUBLIC SUBSIDY OF PRIVATE ACTIVITY 57 (1991).

79. *See* TEMEL, *supra* note 54, at 27–29.

80. *See id.* at 27, 133.

81. *Id.* at 27.

82. Robbins & Simonsen, *supra* note 74, at 55 (Tax-Exempt Interest Rate = Taxable Interest Rate x (1 - Marginal Tax Rate). However, studies have demonstrated that tax-exempt interest rates are higher than calculated by using this formula. *Id.* at 55–56. This phenomenon is referred to as the "municipal bond puzzle," and the hypotheses for why this occurs in the municipal bond market are beyond the scope of this article. *See id.* at 56 & n.1.

federal income tax (subject to alternative minimum tax if applicable). A taxpayer with a marginal tax rate (the tax rate on the last dollar earned) of 28% who purchases a taxable bond with a 5.5% yield receives $550 of interest income. Out of that income, the taxpayer pays $154 of federal tax and has $396 of after-tax income. A taxpayer with a marginal tax rate of 33% who purchases a taxable bond with a 5.5% yield receives $550 of interest income. Out of that income, the taxpayer pays $181.50 of federal tax and has $368.50 of after-tax income.[83] The lower rate provides state and local governments with a cheaper way to finance their projects.[84] Exempting the interest on municipal bonds is an expenditure of the federal government in foregone taxes payable by investors.[85] The following example illustrates the cost to the federal government:

> A state government issues a $10 million bond with two investors investing equally. One investor has a marginal rate of 33% and the other has a marginal rate of 25%. The tax-exempt rate for the issuer is 4.5%, comparable to a taxable rate of 6%. The issuer saves $150,000 in interest that is payable to the investors (1.5% difference between 6% and 4.5% times $10 million). The federal government's cost of foregone taxes is $99,000 for the investor with a marginal tax rate of 33% and $75,000 for the investor with a marginal tax rate of 25%. The total cost in foregone revenue for the federal government is $174,000.[86]

In the above example, the federal subsidy for the state issuer amounts to $150,000 in interest savings. However, the subsidy cost the federal government $174,000 in foregone tax revenue.[87]

For years, state and local governments have used tax-exempt funding for urban development.[88] Tax-exempt municipal bonds are a vital source of funding for new schools, highways, ports, hospitals, airports, bridges, etc.[89] Tax-exempt status gives state and local governments a financial vehicle to accomplish these projects by subsidizing the cost of capital for public capital

83. *See* TEMEL, *supra* note 54, at 28 (providing a tax-exempt taxable equivalent yield rate chart using tax year 2000 tax rates for individuals).

84. *Id.* at 27.

85. Robbins & Simonsen, *supra* note 74, at 56.

86. *See id.* (summarizing an illustration and table).

87. *Id.*; *see also supra* Part V for a description of the subsidy of tax-exempt and taxable bonds.

88. Peter H. Seed, *Public Purpose, Governmental Bonds, and the Need for Rational Bright-Line Rules*, 11 MUN. FIN. J. 331, 339 (1990); *see* TEMEL, *supra* note 54, at ix (noting that in 1999, $263 billion of municipal bonds were sold to construct capital projects such as affordable housing, transportation facilities, education facilities, water supply and sewer facilities, and other qualified governmental use projects).

89. TEMEL, *supra* note 54, at 1.

formation.[90] In addition to funding capital projects (projects producing an asset that has a useful life over one year), municipal bonds are also used to fund the cash flow deficits of state and local governments.[91]

B. Authority to Issue Bonds

A municipal bond is an obligation[92] of a state, the District of Columbia, a U.S. possession, or a political subdivision thereof,[93] and certain Native American tribal governments.[94] A qualified government unit does not include the United States or any agency or instrumentality of the United States.[95] Qualified government units may be local government entities created by a state pursuant to state statute or state constitution.[96] Local government entities include towns, cities, counties, school districts, and local government entities delegated authority by state or local statute that are responsible for a particular service or program.[97]

C. Long-Term and Short-Term Bonds

A qualified government unit or an entity granted statutory authority to issue tax-exempt debt may issue short- or long-term bonds. Long-term bonds are bonds where principal is not due for repayment within ten years but may extend the repayment up to forty years.[98] Several types of municipal bonds can

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90. *See* ZIMMERMAN, *supra* note 78, at 122.

91. MINTZ ET AL., *supra* note 54, at xv, 9.

92. *See* I.R.C. § 150(a)(1).

93. *Id.* § 103(c); *see, e.g.*, I.R.S. Priv. Ltr. Rul. 96-47-019 (Nov. 22, 1996).

94. I.R.C. § 7871(a)(4); *see* I.R.S. Tech. Adv. Mem. 2007-04-019 (Jan. 26, 2007) (discussing the treatment of Indian tribal corporations); I.R.S. Tech. Adv. Mem. 2006-03-028 (Jan. 20, 2006) (same); I.R.S. Field Serv. Advisory 2002-47-012 (Nov. 22, 2002) (same); I.R.S. Priv. Ltr. Rul. 2001-48-020 (Nov. 30, 2001) (same); I.R.S. Priv. Ltr. Rul. 98-47-018 (Nov. 20, 1998) (same); *see also* STAFF OF JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1151 n.41 (Comm. Print 1986).

95. I.R.C. § 150(a)(2).

96. *See* TEMEL, *supra* note 54, at 3–4.

97. MINTZ ET AL., *supra* note 54, at 101–04; TEMEL, *supra* note 54, at 50 (explaining authorities and special debt-issuing districts and providing that examples of such entities known as authorities are airport authorities that issue revenue bonds to finance the building of an airport and housing authorities that issue revenue bonds to finance the construction of housing); M. David Gelfand, *Debt Ceilings and Other Restrictions on Debt Financing: Compliance, Avoidance, and Evasion*, *in* STATE AND LOCAL GOVERNMENT DEBT FINANCING, *supra* note 58, § 9:16. The bonds issued by these entities are revenue bonds, described *supra* Part III.A, and are typically issued by government entities that are responsible for the services or programs financed by the bonds.

98. MINTZ ET AL., *supra* note 54, at 9.

be considered long-term, however the two most common are general obligation and revenue.[99]

In contrast to long-term bonds, short-term bonds are typically bonds issued with a term of one year or less and paid within the fiscal year.[100] Examples of short-term bonds include tax anticipation notes (TANs),[101] tax and revenue anticipation notes (TRANs),[102] revenue anticipation notes (RANs),[103] bond anticipation notes (BANs),[104] and general obligation notes.[105] TANs or TRANs are secured and paid by the receipt of ad valorem property taxes or some other type of local taxes.[106] RANs are secured and paid by the receipt of sales and use taxes and other fees or taxes other than taxes from real estate.[107] BANs are typically used for short-term construction financing and are paid back when the permanent financing is obtained.[108] BANs, TANs, TRANs, and RANs are the standard short-term debt instruments issued, but state and local entities have other creative financing tools such as tax-exempt commercial paper, bonds with warrants, tender option bonds, variable rate securities, bond pools, and taxable bonds.[109] Short-term bonds have special restrictions on the use of their proceeds.[110]

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99. See *supra* Part III.A for a detailed discussion of general obligation and revenue bonds.

100. *See* MINTZ ET AL., *supra* note 54, at 9.

101. TEMEL, *supra* note 54, at 34 (noting that tax anticipation notes are short-term bonds issued and secured by future tax revenue).

102. *Id.* at 34 (noting that tax and revenue anticipation notes are issued and secured by future tax revenue or revenue from sources other than assessed taxes and TRANs provide an inexpensive method of financing short-term cash shortfalls).

103. *Id.* at 34 (bonds issued in anticipation of other sources of future revenue).

104. *Id.* (bonds issued as interim financing in anticipation of a future bond offering).

105. *Id.* (short-term general obligation notes).

106. MINTZ ET AL., *supra* note 54, at 9.

107. *Id.*

108. *Id.*

109. *Id.* at 9–11.

110. This article does not address the complicated tax arbitrage rules under I.R.C. § 148 associated with short-term bonds. I.R.C. § 103(a) provides generally that gross income does not include interest on any state or local bond. Section 103(a) does not apply to any arbitrage bond (within the meaning of I.R.C. § 148). I.R.C. § 103(b)(2). Section 148(f) provides that certain earnings on nonpurpose investments allocable to the gross proceeds of an issue generally are treated as an arbitrage bond unless the issuer rebates to the federal government any arbitrage profits earned from investing the gross proceeds of such issue in higher-yielding investments. *See* Perry E. Israel, *Summary of Federal Tax Requirements for Tax-Exempt Bonds*, *in* THE HANDBOOK OF MUNICIPAL BONDS, *supra* note 37, at 91, 93–100 (discussing arbitrage).

D. Process of Issuing Municipal Bonds

The process of issuing short-term or long-term municipal bonds involves essentially the same parties, procedures, and practices. Elected and appointed government officials of the government entities issuing the bonds make the initial decision to issue the bonds for a particular project.[111] They are responsible for complying with state or local law authorizing the issuance, providing the financial and budgetary information supporting the issuance, determining whether the issuance is in compliance with public debt limitations as prescribed by the state, and providing the necessary notice of the issuance to the community they serve.[112] A state's authorization of issuing debt is typically found in the state's constitution or statute.[113] Depending on the state's constitution or statute, a state may be required to mandate a referendum and debt elections for the approval of bonds.[114] Local government entities may require approval of a state agency or the attorney general's office.[115]

1. Financial Advisor

When government officials have obtained and met the necessary approvals, the issuer typically will retain a financial advisor for the issuance.[116] The financial advisor is responsible for preparing empirical data to support the financial feasibility of the issuance and assists in determining how the debt will be structured, the method of sale of the debt, and to a limited degree, the marketing of the debt.[117] In other words, will the issuer be able to pay the interest and principal of the bonds, the debt service, with the revenue stream pledged to pay the bonds? The independence of the financial advisor is important to the credibility and viability of the bond issuance proposal and is particularly important when a bond proposal is subject to public approval by referendum.[118]

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111. MINTZ ET AL., *supra* note 54, at 19; *see* Robert H. Freilich, *Authority of State and Local Governments to Issue Debt: Sources and Limitations*, *in* STATE AND LOCAL GOVERNMENT DEBT FINANCING, *supra* note 58, §§ 1:4, :5.

112. *See* Freilich, *supra* note 111, §§ 1:4, :5, :15, :21.

113. MINTZ ET AL., *supra* note 54, at 58.

114. *Id.* at 59.

115. *Id.*

116. *See id.* at 20; TEMEL, *supra* note 54, at 11.

117. *See* TEMEL, *supra* note 54, at 11.

118. MINTZ ET AL., *supra* note 54, at 20.

2. Bond Counsel

Retaining the financial advisor is only part of the process of assembling the team of professionals necessary for the bond issuance. The most important decision by the issuers in assembling the professionals for the bond issuance is retaining outside counsel to act as bond counsel.[119] Bond counsel is responsible for reviewing and preparing bond documents necessary for the issuance, organizing meetings of the parties to review bond documents, setting the closing schedule of the issuance, and most importantly, providing an opinion on the tax-exempt qualification of the bond issuance.[120] The other parties to the bond issuance, particularly the bondholders, rely on the opinion of bond counsel that the issuance has met all local, state, and federal laws.[121]

Bond counsel has the expertise to provide the necessary legal opinion on the tax-exemption of the bonds, but does not have the expertise to arrange the financing of the bonds.[122] A securities dealer with the expertise to market and sell municipal bonds is essential to a successful bond issuance.[123] This securities dealer, known as an underwriter, assumes the financial risk of buying the bonds at a discount with the expectation of making a profit on the subsequent transaction of selling the bonds to investors.[124] The underwriter is responsible for pricing the bonds, developing a market plan to sell the bonds, establishing the transactional structure of the issuance, establishing the quantitative analysis to support the structure of the issuance, establishing settlement dates for the bond closing, preparing the offering document or prospectus, and reselling the bonds.[125]

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119. Peter W. Salsich Jr., *State Laws Regarding Issuance of Bonds and Notes, in* STATE AND LOCAL GOVERNMENT DEBT FINANCING, *supra* note 58, § 11:50.

120. *See* TEMEL, *supra* note 54, at 63, 65–72 (indicating that bond documents may include an authorizing resolution, bond resolution, indenture, trust agreement, official statement, opinion of bond counsel and other legal opinions, credit enhancing documents, bond purchase agreement, purchase contract, disclosure agreement, and other financing documents).

121. *See* MINTZ ET AL., *supra* note 54, at 21 (indicating that the typical parties to a municipal bond issuance include the government entity issuer, bond counsel, issuer's counsel, underwriter, underwriter's counsel, financial advisor, and bond insurer).

122. *Id.* at 21–22.

123. *See* Christopher J. Mier, *The Role of the Underwriter, in* THE HANDBOOK OF MUNICIPAL BONDS, *supra* note 37, at 265, 265–66; *see also* MINTZ ET AL., *supra* note 54, at 22–24.

124. *See* MINTZ ET AL., *supra* note 54, at 22–24.

125. *See id.* at 22.

3. Underwriter

The marketing of the bonds is done through the offering document, which is a comprehensive disclosure document that advertises the public sale of the bonds and provides potential investors with details of the security and financial information about the issuer and the bonds.[126] This offering document, also known as an official statement, is circulated for the issuer to potential investors to advertise the sale of the bonds.[127] Because investors are relying on the information in the official statement to make their investment decision, the official statement or any other offering document is subject to the antifraud regulations found in the Securities Act of 1933 (the "1933 Act")[128] and the Securities Exchange Act of 1934 (the "1934 Act").[129] The underwriter has an obligation to potential investors to exercise due diligence in the review of all the information received from the issuer that is contained in the official statement.[130]

The market place for investors in the bonds consists of two markets: the primary and secondary markets.[131] In the primary market, investors are purchasing new bonds of issuers with the proceeds from the sale going to the issuer. The secondary market involves the resale of bonds from investor to investor.[132] The sale of municipal bonds is accomplished through one of three

126. *See* TEMEL, *supra* note 54, at 66–70.

127. *Id.* at 66.

128. Securities Act of 1933, ch. 38, 48 Stat. 74 (current version at 15 U.S.C. §§ 77a–77aa (2006)). The antifraud provisions are found in sections 11, 12(2), and 17 of the 1933 Act. *See id.* §§ 11, 12(2), 17. Municipal bonds are considered "exempt securities" and are not subject to the registration requirements of the 1933 Act. *Id.* § 3(2) (current version at 15 U.S.C. § 77c(a)(2) (2006)). Congress determined that investors in municipal securities were sophisticated and well-informed and did not need the protection that registration provided corporate securities investors. *See* 77 CONG. REC. 2978–84 (1933). "The purpose of the bill is to protect the investing public and honest business." *Id.* at 2983.

129. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (current version at 15 U.S.C. §§ 78a–78hh (2006 & Supp. 2009)). Antifraud provisions of the 1934 Act are found in section 10(b). *Id.* § 10(b). Municipal bonds are considered "exempt securities" under section 3(a)(12) of the 1934 Act and are not subject to the reporting requirements of the 1934 Act. Congress determined that investors in municipal securities were sophisticated and well-informed and did not need the protection that registration provided corporate securities investors. *See* 78 CONG. REC. 2270–71 (1934) (Sen. Fletcher stating that the purpose of the act is to "bring[] safety to the general public in the field of investment and finance").

130. *See* Mary G. Wilson, *The Role of Counsel to the Underwriters*, *in* THE HANDBOOK OF MUNICIPAL BONDS, *supra* note 37, at 79, 83. Due diligence requires the underwriter to verify the information provided by the issuer. *See id.* Among other things, the underwriter reviews the authority of the issuer to issue the bonds and reviews outstanding liabilities stated by the issuer. *See id.*

131. TEMEL, *supra* note 54, at 2.

132. *Id.*

methods: competitive bidding, negotiated sale, or private placement.[133] In the competitive bidding process, underwriters who want to purchase the bonds submit bids to the issuer, and the bid with the lowest cost is awarded the contract to underwrite the bonds.[134] In a negotiated sale, the issuer selects the underwriter through a request for proposals (RFP) that is sent out by the issuer to selected underwriters.[135] The RFP provides the specific criteria to be evaluated, such as experience, familiarity with the issuer's previous bond issuances, management fees and estimated expenses, list of anticipated services, and preliminary ideas about the structure of the deal in evaluating the proposal response of potential underwriters.[136] Both competitive and negotiated sales involve an underwriter purchasing the bonds from the issuer and reselling them in the primary or secondary municipal market.[137] The underwriter is compensated through the purchase of the bonds at less than the issue price, otherwise known as the gross underwriter spread.[138] The underwriter works with salespeople within the municipal bond markets to determine the price of the issuance and to circulate the official statement.[139] Underwriters typically have more expertise in marketing, pricing, and selling bonds than an issuer.[140] The public offering of the bonds occurs when the underwriter issues the official statement or other offering document in the municipal bond secondary market.[141]

The third method of selling municipal bonds, private placement, is used less frequently than the competitive and negotiated sales methods.[142] In a private placement, a small group of investors agrees to buy the bonds directly from the issuer, prior to public offering in the primary market.[143] Private placements are typically for small-size bond issuances and account for a small percentage of total sale of bonds.[144]

Bonds in a private placement or public offering—competitive bidding or negotiated sale—may be purchased by a group of underwriters called a

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133. Jung Peng et al., *Method of Sale in the Municipal Bond Market*, *in* THE HANDBOOK OF MUNICIPAL BONDS, *supra* note 37, at 51, 52; *see* TEMEL, *supra* note 54, at 64, 88–90.

134. Peng et al., *supra* note 133, at 52–54; TEMEL, *supra* note 54, at 88–90.

135. *See* TEMEL, *supra* note 54, at 86–88.

136. *See id.* at 7.

137. Peng et al., *supra* note 133, at 52; *see* Miller & Coniglio, *supra* note 58, §§ 2:10-:11.

138. Peng et al., *supra* note 133, at 54.

139. *Id.*

140. *See* TEMEL, *supra* note 54, at 7.

141. *See id.* at 66–70.

142. Peng et al., *supra* note 133, at 52.

143. *Id.*

144. *Id.*

syndicate.[145] The syndicate has a lead manager responsible for coordinating the deal, and allows underwriters to share in the underwriting process.[146]

4. *Credit Rating Agencies*

A key aspect of the ability of the underwriter to market and sell the bonds is the issuer receiving a favorable bond rating from one of the nationally recognized municipal bond rating companies. The three major municipal bond rating companies are Moody's Investor Service (Moody's),[147] Standard & Poor's (S&P),[148] and Fitch Ratings (Fitch).[149] A credit rating company makes an assessment of the issuer's ability to meet the obligation of paying the debt service on the bonds.[150] This assessment of the creditworthiness of the issuer is typically accomplished by evaluating the issuer's financial condition (review of its financial records), debt structure, demographic factors, management practices, and administration of the issuer's governing body.[151] Investors assume that a more favorable credit rating equates to a lower risk of default on the bonds.[152] Moreover, a favorable credit rating directly affects the price of the bonds, the interest rate yield that investors are willing to accept for purchasing the bonds, the need for bond insurance, and the cost of such bond insurance.[153] A lower credit rating translates to a higher assessment of possible default of the issuer, which in turn increases the cost of issuing the bonds for the issuer. A low credit rating will require the issuer to pay a higher yield to

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145. *See* Miller & Coniglio, *supra* note 58, § 2.12 (providing a general definition of underwriting syndications); *see also* TEMEL, *supra* note 54, at 90–91, 94–95 (describing a syndicate for a negotiated sale and for competitive bidding).

146. Miller & Coniglio, *supra* note 58, § 2.12.

147. The predecessor of Moody's Investor Services was founded in 1900, and in 1909 began analysis of the stocks and bonds of America's railroads. *See Moody's History: A Century of Market Leadership*, MOODY'S CORP., http://v3.moodys.com/Pages/atc001.aspx (last visited May 17, 2011).

148. Standard & Poor's was created in 1868 providing a financial manual on America's railroads. *See A History of Standard & Poor's*, STANDARD & POOR'S, http://www.standardandpoors.com/about-sp/timeline/en/us/ (last visited May 17, 2011).

149. Fitch Ratings was founded in 1913. *See The History of Fitch Ratings*, FITCH RATINGS, http://www.fitchratings.com/jsp/creditdesk/AboutFitch.faces?context=1&detail=3 (last visited May 17, 2011); *see* MINTZ ET AL., *supra* note 54, at 29.

150. MINTZ ET AL., *supra* note 54, at 29; Edward A. Rabson, *The Role of the Rating Agencies*, *in* THE HANDBOOK OF MUNICIPAL BONDS, *supra* note 37, at 223.

151. *Credit Rating Agencies*, *in* STATE AND LOCAL GOVERNMENT DEBT FINANCING, *supra* note 58, § 15:3.

152. *See generally* TEMEL, *supra* note 54, at 161–72 (the risk of default is lower with a higher credit rating).

153. Donald King Cirillo, *How to Analyze the Municipal Bond Insurers and the Bonds They Insure*, *in* THE HANDBOOK OF MUNICIPAL BONDS, *supra* note 37, at 1085, 1087–88.

investors to entice them to purchase the bonds and may require credit enhancements such as a letter of credit or bond insurance to support the issuance.[154]

The credit rating process begins when the issuer applies for a rating of the issuance from one or all of the rating agencies.[155] A representative of the issuer will contact the bond rating agency and make a formal request for the rating of the issuer.[156] The application process requires a comprehensive submission of financial records.[157] Once the issuer completes the credit rating application, the credit rating agency will issue its credit rating. The credit rating grades provided by Moody's, Standard & Poor's and Fitch are slightly different, but the rating processes of all three are very similar.[158]

5. *Bond Insurers*

The lower-rated issuer may seek credit enhancement to increase the credit rating of its bonds.[159] Credit enhancement may address bond purchasers'

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154. *Id.*

155. MINTZ ET AL., *supra* note 54, at 35.

156. *Id.*

157. TEMEL, *supra* note 54, at 171–72.

158. *See* MINTZ ET AL., *supra* note 54, at 37–38. The table below shows the rating grades of each of the three major rating agencies.

	Moody's	**Standard & Poor's**	**Fitch**
Best Quality	Aaa	AAA	AAA
High Quality	Aa1 Aa2 Aa3	AA+ AA AA-	AA+ AA AA-
Upper Medium Grade	A1 A2 A3	A+ A A-	A+ A A-
Medium Grade	Baa1 Baa2 Baa3	BBB+ BBB BBB-	BBB+ BBB BBB-
Low Grade	Caa Ca C	CCC CC CD	CCC CC C
Lowest Grade		D SD	RD D

159. TEMEL, *supra* note 54, at 12–13.

concerns about the quality of the issuer's bonds.[160] The use of municipal bond insurance by issuers was introduced to the municipal bond market in 1971 when AMBAC Indemnity Corporation (later known as AMBAC), an insurer with a triple-A credit rating, issued its first municipal bond policy.[161] By 2007, there were seven bond insurers that had received a triple-A rating from at least one of the three major credit rating agencies—Moody's, S&P, and Fitch.[162] By the end of 2007, approximately 50% of all bond issuances, nearly $600 billion worth of bonds, were enhanced by bond insurance.[163]

Bond insurance can provide cost savings to the issuer by reducing its interest cost paid to bondholders.[164] Interest costs are generally reduced if the bond insurer's own underlying credit rating is equal to or exceeds that of the issuer.[165] The effect of the insurance is to raise the credit rating of the issuer.[166] Bond insurance provides issuers with better access to the municipal bond market at a lower cost.[167] A typical scenario that illustrates how bond insurance works is as follows:

> A municipal bond issuer with a credit rating of single-A purchases bond insurance from a bond insurer that is rated triple-A by one of the three major credit rating agencies. Increasing the single-A rating to a triple-A rating may save the issuer in borrowing costs of up to 2% on a 30-year maturity bond. The net interest cost savings to the issuer over the life of the bonds may reach as much as 1.6% per year.[168]

Bond insurance for municipal bonds provides the issuer with a third-party guarantee to pay the coupon interest and principal of the bonds in event of default of the issuer.[169] Thus, if a bond issuer were to default (i.e., fail to pay the interest and principal of the bonds), the bondholders would be guaranteed payment by the bond insurer.[170] Only the actual debt holder (the bondholder)

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160. *Id.*

161. Cirillo, *supra* note 153, at 1091.

162. *Id.* The seven bond insurers were AMBAC Assurance Corp. (AMBAC), Assured Guaranty Corp., CIFG Financial Guaranty Insurance Corp. (FGIC), Financial Security Assurance Inc. (FSA), MBIA Insurance Corp. (MBIA), and XL Capital Assurance, Inc. (XL). *Id.*

163. *Id.* at 1085.

164. *Id.* at 1088.

165. *Id.*

166. *See id.*

167. *Id.* at 1099.

168. *Id.* at 1088–89 (providing an illustration of how bond insurance saves borrowing costs for the issuer).

169. MINTZ ET AL., *supra* note 54, at 27; *see generally* Vikram Nanda & Rajdeep Singh, *Bond Insurance: What Is Special About Munis?*, 59 J. FIN. 2253 (2004) (providing an overview of the municipal bond insurance industry and offering a tax-based rationale for the growth of the industry).

170. Cirillo, *supra* note 153, at 1086.

is eligible to receive benefits of the bond insurance policy.[171] The issuer normally pays the insurer a premium at the time of issuance, the amount of which is determined by perceived risk of default by the issuer.[172]

IV. IMPAIRMENT OF THE MUNICIPAL BOND MARKET

A. Effect of Subprime Mortgage Crisis on Issuing Municipal Bonds

No one can exactly state when the subprime mortgage crisis began, but by mid-2006, the U.S. housing boom, with record increases in assessed value of residential homes that began in 2000, ended with a sudden drop in values.[173] The drop in values began a series of events that led to record increases in household mortgage delinquencies throughout the country. These mortgages were primarily "subprime" and adjustable rate mortgages (ARM).[174] A subprime mortgage generally is a consumer mortgage that is targeted to borrowers with low credit scores.[175] These borrowers typically have unfavorable ratios of borrower's debt to income or assets and unfavorable ratios of loan to value or collateral.[176] These mortgages were intended to make home ownership more available, but were also subject to greater risk of default for failure to make required payments due to the creditworthiness of the borrowers. Subprime and ARM mortgages were accumulated and packaged as securities for sale by brokers, and investors ranging from major financial institutions to everyday private consumer investors purchased them in abundance.[177] When the record drop in assessed values of U.S. residential housing occurred in mid-2006, many of the housing units fell below their mortgage value, and many homeowners had an incentive to enter into foreclosure.[178] The massive number of foreclosures made many of the mortgage-backed securities worthless, and the wealth of consumers and financial institutions that invested in them was severely compromised.[179] The

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171. *Id.*

172. *See id.*

173. *See* Nestor M. Davidson & Rashmi Dyal-Chand, *Property in Crisis*, 78 FORDHAM L. REV. 1607, 1624–29 (2010).

174. Christine Daleiden, *Understanding Subprime Mortgages*, 12 HAW. BAR J. 6, 6–9 (Mar. 2008).

175. *Id.* at 6.

176. *See* Davidson & Dyal-Chand, *supra* note 173, at 1625–26.

177. *See id.* at 1626.

178. *See id.* at 1627–28.

179. Kevin T. Jackson, *The Scandal Beneath the Financial Crisis: Getting a View from a Moral-Cultural Mental Model*, 33 HARV. J.L. & PUB. POL'Y 735, 742 (2010).

subprime mortgage crisis affected credit liquidity in other capital markets, and by early 2008 the effects of the subprime mortgage crisis were being reflected in the municipal bond market.[180] The municipal bond market was immobilized because of the uncertainty of the credit markets, and the borrowing costs for state and local government entities that issue municipal bonds increased substantially.[181]

1. Fewer Underwriters and Financial Institutions

The collapse of the credit markets due to the subprime mortgage crisis affected major financial institutions that underwrite municipal bonds. In September 2008, two major financial institutions that had underwritten bonds became financially crippled and unable to sustain their market share of underwriting—Merrill Lynch was acquired by Bank of America and Lehman Brothers filed bankruptcy.[182] In addition to the loss of two major financial institutions that provided the municipal bond market with underwriters, the credit markets were also weakened by the largest bank failure, endured by Washington Mutual, which was acquired by JPMorgan Chase.[183] By late 2008, banks and other financial institutions were not participating in the municipal bond market, which caused borrowing costs for state and local governments to increase dramatically, including underwriting fees.[184]

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180. Jessica Holzer, *Tax Change Could Assist State, Local Governments*, THE HILL (Mar. 3, 2008, 2:05 PM), http://thehill.com/business-a-lobbying/3485-tax-change-could-assist-state-local-governments.

181. *See* Daniel Wagner, *Credit Crunch Makes Cities' Borrowing More Costly*, USA TODAY, Sept. 26, 2008, http://www.usatoday.com/money/economy/2008-09-26-4259086187_x.htm (describing state and local issuers' increased cost of issuing bonds; for example, Grand Rapids, Michigan paid $750,000 more than it expected in interest on a $15 million, 10-year refinancing bond, and Louisiana's 2007 fiscal budget was increased by $14.3 billion to account for higher borrowing costs).

182. Davidson & Dyal-Chand, *supra* note 173, at 1628; *see also* Keith B. Richburg & Karl Vick, *Fiscal Crisis Is Hitting Some States Hard: California Seeks Emergency Loan*, WASH. POST, Oct. 4, 2008, at A02 (quoting Matt Fabian, senior analyst with Municipal Markets Advisors, commenting on the collapse of Wall Street investment firms that underwrote municipal bonds, "[t]he muni industry has lost almost half of its large underwriters").

183. Davidson & Dyal-Chand, *supra* note 173, at 1628.

184. *Economic Recovery and Job Creation Through Investment in America: Hearing on H.R. 333 and H.R. 6308 Before the H. Comm. on Ways & Means*, 110th Cong. 45 (2008) (statement of Timothy Firestine, Chief Administrative Officer, Montgomery County, Maryland) [hereinafter *Economic Recovery & Job Creation Hearing*].

2. *Increased Costs of Issuing Bonds*

In 2007 and 2008, issuers cancelled or delayed over $20 billion of bond issuances due to dramatic increases in borrowing costs for bond issuers.[185] With the instability of the credit markets, investors were demanding higher returns on their investments to compensate for their greater apparent risks.[186] In early 2007, the yield for long-term municipal bonds averaged 4.40%, but by mid-October, the yield was over 6%.[187] In 2008, the yield demanded on short-term bonds increased from 2% to 9–10%.[188] This increase in yield was not due to a decline in the creditworthiness of the state or local bond issuers but to the disruption of the capital markets due to the subprime mortgage crisis.[189] Over and over, state and local issuers experienced increased borrowing costs. For the Los Angeles Metro Transit Authority, the interest rate for $132 million in variable rate bonds increased from 1% to 12%, which increased monthly interest on the bonds by $1.2 million.[190] In Michigan, the cost of variable rate loans for school has increased from 3.25% to 10%.[191]

3. *Instability with Municipal Bond Insurers*

The municipal bond insurance industry has drastically changed since late 2007. The seven major bond insurers with triple-A credit ratings had insured many subprime mortgage securities, and when the default rate on the underlying mortgages increased dramatically, these bond insurers were obligated to honor their guarantees and suffered significant losses.[192] The financial health and creditworthiness of these bond insurers were compromised by the cascading defaults on subprime mortgages, and the three major credit rating agencies (i.e., Moody's, S&P, and Fitch) made adjustments to their credit ratings accordingly.[193] On July 1, 2009, two of the remaining municipal

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185. *See* Wagner, *supra* note 181.

186. *See Economic Recovery & Job Creation Hearing*, *supra* note 184, at 45 (statement of Timothy Firestine).

187. *Id.* at 46.

188. *Id.*

189. *Id.*

190. Michael A. Hiltzik, *States, Cities Face Sky-High Payouts on Municipal Bonds*, L.A. TIMES, Nov. 22, 2008, http://articles.latimes.com/2008/nov/22/business/fi-muni22.

191. Richburg & Vick, *supra* note 182.

192. Richard J. Miller, *Creative State and Local Financing Techniques*, *in* STATE AND LOCAL GOVERNMENT DEBT FINANCING, *supra* note 58, § 4:33.

193. *See id.*

bond insurers with triple-A ratings became one entity, with the acquisition of Financial Security Assurance by Assured Guaranty Corporation.[194] The new bond insurer is Assured Guaranty LTD and is the lone municipal bond insurer with a triple-A rating.[195] A triple-A rating has been necessary since 1971, when insurance was first used to enhance the creditworthiness of bonds.[196] Bond insurance provides issuers with credit rating problems the ability to "buy" a triple-A credit rating.[197] With only one triple-A rated bond insurer, issuers find it more difficult to use credit enhancement through insurance and thus have fewer options to reduce interest costs on their issuances.[198]

The collapse of the ratings of bond insurers has caused lawsuits to be filed by cities claiming that the bond insurance they have purchased is now worthless.[199] The cities of Los Angeles and New Orleans filed lawsuits claiming that bond insurers failed to disclose their risky investments in subprime investments.[200]

4. Challenge of the Credit Rating System

As explained earlier, the creditworthiness of an issuer of municipal bonds is generally determined prior to an issuance by credit rating agencies.[201] Receiving a credit rating is generally necessary for an issuer to be able to sell and market its bonds.[202] With immobilization of the municipal bond market and the increase in bond issuance fees, issuers were not only challenging the underwriters and bond insurers for the increase of their fees, they were also challenging the necessity of receiving a credit rating.[203] Some issuers questioned whether they were realizing added value for the payment to credit

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194. Dan Seymour, *Assured Wraps up FSA Purchase, Cements Hold on Industry*, BOND BUYER, July 2, 2009, http://www.bondbuyer.com/issues/118_126/-305047-1.html.

195. Dan Seymour, *Assured, the Only Game in Town, Hikes Prices*, BOND BUYER, Dec. 18, 2009, http://www.bondbuyer.com/issues/118_242/assured-hikes-prices-1005207-1.html.

196. *See* Cirillo, *supra* note 153, at 1099.

197. *See id.*

198. Miller, *supra* note 192, § 4.33; *see generally* Marvin M. Bagwell, *Can't Live Without Air: Title Insurance and the Bursting of the Real Estate Bubble*, 30 PACE L. REV. 180 (2009).

199. David Anderson & Sarah Hodges, *Credit Crisis Litigation: An Overview of Issues and Outcomes*, BANKING & FIN. SERV. POL'Y REP., June 2009, at 4 & n.28, *available at* http://www.ccsb.com/pdf/Publications/Subprime%20Articles/Credit_Crisis_Litigation.pdf.

200. *Id.* at 4 n.28.

201. *See* TEMEL, *supra* note 54, at 161–72 (explaining the ratings process).

202. *See id.* at 12.

203. Julie Creswell & Vikas Bajaj, *States and Cities Start Rebelling on Bond Ratings: Does Wall Street Underrate Main Street?*, N.Y. TIMES, Mar. 3, 2008, http://www.nytimes.com/2008/03/03/business/03bond.html.

rating agencies for ratings that did not adequately reflect the issuer's creditworthiness.[204] They claim that there is not a true relationship between the risk of default and the credit rating because, although state and local governments hardly ever default on their issuances, some receive low credit ratings.[205] Triple-A rated government issuers are also paying more for issuing bonds.[206] The cost to taxpayers is billions of dollars in the form of unfairly high interest rates.[207] California has had to pay $102 million to insure more than $9 billion in general obligation debt between 2003 and 2007.[208]

Congress began to respond to the complaints about credit rating agencies. Representative Barney Frank (D-MA), Chair of the House Financial Services Committee, proposed legislation—the Municipal Bond Fairness Act—to reform the bond rating system.[209] The Act would require a uniform and transparent credit risk evaluation for bond issuers, and it addresses the unequal treatment of credit evaluation of municipal and corporate bonds.[210] On May 21, 2009, the bill was referred to the House Committee on Financial Services. Credit rating system reform for municipal bonds is still being addressed by issuers, credit rating agencies, and the many professionals involved in the issuance and sale of municipal bonds.

B. Effect of the Economic Recession on Cash Flow

According to the National Bureau of Economic Research, the United States entered a recession in December 2007.[211] It is estimated that U.S.

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204. *See id.* The controversy over the credit ratings of municipal bonds is a topic that goes beyond the scope of this article. The author will examine claims of state and local issuers that credit ratings by the three major credit rating agencies do not accurately reflect the creditworthiness and risk of default of municipal bond issuers in another article.

205. *Id.*

206. *Economic Recovery & Job Creation Hearing*, *supra* note 184, at 47 (Timothy Firestine, Chief Administrative Officer, Montgomery County, Maryland stating that, "even governments like Montgomery County, which is rated AAA, is and will be paying the price due to both the fallout in the capital markets and the federal government's lack of attention to our sector. Thus, it will be more expensive for governments to provide public safety programs, schools, roads, firehouses, libraries, public hospitals, and other services that the public relies upon, or these services will need to be reduced.").

207. Creswell & Bajaj, *supra* note 203.

208. *Id.*

209. Municipal Bond Fairness Act, H.R. 2549, 111th Cong. (2009).

210. *Id.*

211. *See* Chris Isidore, *It's Official: Recession Since Dec. '07*, CNNMONEY.COM (Dec. 1, 2008, 5:40 PM), http://money.cnn.com/2008/12/01/news/economy/recession/index.htm; *see also* Ravi Jagannathan et al., *Why Are We in a Recession? The Financial Crisis Is the Symptom Not the Disease* (Nat'l Bureau of Econ. Research, Working Paper No. 15404, 2009), *available at* http://www.nber.org/papers/w15404.pdf.

employers cut over 8 million jobs during the recession,[212] and the average nationwide unemployment rate for 2010 was 9.6%.[213] The unemployment rate has reduced the amount of income taxes collected by state and local governments.[214] State tax collections continued to decline in 2009, with individual income tax collections down 11.7% from 2008.[215] Of the forty-three states that assess individual income taxes, thirty-nine states attributed their decrease in tax collections to a decrease in individual income tax collections.[216] In 2009, most states reported a decline in tax collections, with fourteen reporting a decrease of 10% or greater.[217] Less revenue collected by state and local governments due to the recession means that state and local governments must make budgetary cuts to meet existing debt service obligations.[218] New issuance of short-term bonds will need to be adjusted to account for less revenue collected.[219]

1. States

A number of states are reporting cash flow deficits for their fiscal year 2010–2011.[220] Three noteworthy states are California, Illinois, and New York.

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212. *See* Chris Isidore, *Poof: Another 800,000 Jobs Disappear*, CNNMONEY.COM (Feb. 4, 2010, 1:31 PM ET), http://money.cnn.com/2010/02/04/news/economy/jobs_outlook/index.htm?section=money_topstories&utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+rss%2Fmoney_topstories+%28Top+Stories%29.

213. Bureau of Labor Statistics, U.S. Dep't of Labor, *Labor Force Statistics from the Current Population Survey*, http://www.bls.gov/cps/ (last visited May 23, 2011).

214. *See* Thomas Pyle, *America Deserves a Better Energy Plan: Oleaginous Democrats Squeeze Oil, Gas Production and Jobs*, WASH. TIMES, Aug. 13, 2010, at B01 ("[A]lmost 8.4 million jobs have been lost during this recession (almost 5 million since January 2009). . . ."); *see also* Editorial, *So Much for Jobs, Jobs, Jobs*, N.Y. TIMES, Mar. 6, 2010, at A20 ("8.4 million jobs have been lost since the recession began in December 2007."); John Harwood, *Mystery for White House: Where Did the Jobs Go?*, N.Y. TIMES, July 19, 2010, at A13 ("[E]ight million jobs lost since the recession began. . . .").

215. U.S. CENSUS BUREAU, STATE GOVERNMENT TAX COLLECTIONS IN 2009, at 1 (2010), *available at* http://www2.census.gov/govs/statetax/2009stcreport.pdf.

216. *Id.* at 3. The three states with the highest decline in individual income tax collections were Arizona at 42.5%, Tennessee at 23.8%, and New Mexico at 23.2%. *Id.*

217. *Id.* at 1. State tax collection sources include individual income tax, corporation net income taxes, general sales and gross receipts taxes, license taxes, property taxes, and other taxes. *Id.* The fourteen states that reported a decrease of 10% or greater in tax collections are Alaska, Arizona, California, Connecticut, Florida, Georgia, Idaho, Massachusetts, New Jersey, New Mexico, North Carolina, South Carolina, Utah, and Virginia. *Id.*

218. William Selway, *California May Cut Pay, Illinois Holds Bills to Bar Downgrades*, BUS. WK., July 14, 2010, http://www.businessweek.com/news/2010-07-14/california-may-cut-pay-illinois-holds-bills-to-bar-downgrades.html.

219. *Id.*

220. *See* Audi, *supra* note 33 (providing a chart that lists the states claiming cash flow deficits).

California projected a $24 billion budget gap for the fiscal year 2010–2011, which started past July 1, 2010.[221] The Illinois Comptroller projected the 2010 budget deficit for the state at $8.95 billion.[222] As of June 2010, New York's 2010 budget deficit was $9.2 billion.[223]

2. Cities, Towns, Counties

Cities and other local entities are also experiencing cash deficits. Los Angeles estimates a budget deficit of $1 billion over the next few years, and the city is planning to cut more than 4,000 city jobs.[224] The city has also asked city workers to take as high as a 10% pay cut to help its cash flow deficit.[225] The mayor of Philadelphia proposed a trash collection fee to help with the city's projected $125 to $150 million deficit for fiscal year 2011.[226] In Colorado Springs, the cash deficit forced the city to turn off one-third of its streetlights, sell police helicopters, and lay off firefighters and beat cops.[227] The city of Flint, Michigan announced that it would reduce trash pickup to every other week to help its $8 million budget deficit.[228] One city, Harrisburg, Pennsylvania, had a cash deficit so severe that city officials considered filing Chapter 9 bankruptcy.[229]

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221. Rich Saskal, *Fitch Downgrades California GO Bonds to A-Minus*, BOND BUYER, June 26, 2009, at 14, *available at* http://www.bondbuyer.com/issues/118_122/-304861-1.html.

222. ILL. OFFICE OF THE COMPTROLLER, TRANSITIONAL FISCAL REPORT/FY 2010 BUDGETARY OUTLOOK 1, *available at* http://www.ioc.state.il.us/ioc-pdf/dwhreportFeb2009.pdf.

223. Joan Gralla, *Cash-Poor NY State May Issue IOUs Like California*, REUTERS (June 10, 2010, 5:58 PM EDT), http://www.reuters.com/article/idUSTRE6536LO20100610.

224. *See* Phil Willon, *L.A. Faces $1-Billion Deficit by 2013; Budget Chief Calls for Pension Reforms*, L.A. TIMES, Nov. 25, 2009, http://latimesblogs.latimes.com/lanow/2009/11/la-faces-1-billion-deficit-by-2013-budget-chief-calls-for-pension-reforms.html (projecting that the deficit for Los Angeles will be $1 billion by 2013); Phil Willon & Maeve Reston, *L.A. City Council Orders 3,000 More Job Cuts*, L.A. TIMES, Feb. 19, 2010, http://articles.latimes.com/2010/feb/19/local/la-me-la-budget19-2010feb19.

225. Steve Lopez, *Would You Take a Pay Cut to Save Your Co-workers' Jobs?*, L.A. TIMES, Feb. 25, 2010, http://latimesblogs.latimes.com/lanow/2010/02/would-you-take-a-pay-cut-to-save-your-co-workers-jobs.html.

226. Patricia Sicilia, *Philadelphia Mayor Proposes Soft Drink Tax and Trash Collection Fees*, ASSOCIATED CONTENT (Mar. 8, 2010), http://www.associatedcontent.com/article/2773554/philadelphia_mayor_proposes_soft_drink.html.

227. Leslie Eaton, *Strapped City Cuts and Cuts and Cuts*, WALL ST. J., Apr. 13, 2010, http://online.wsj.com/article/SB10001424052702303411604575168030083419748.html.

228. Kristin Longley, *Reduced Flint Trash Pick-up Begins Monday: Residents Worry About Onset of Rodents*, MLIVE.COM (Mar. 28, 2010, 10:00 AM), http://www.mlive.com/news/flint/index.ssf/2010/03/reduced_flint_trash_pick-up_be.html.

229. Romy Varghese, *Harrisburg Seeks "Least Worst" Path*, WALL ST. J., Apr. 28, 2010, http://online.wsj.com/article/SB10001424052748704471204575210102200492256.html.

County governments and bond issuing authorities are also experiencing cash flow shortages. Examples include Gwinnett County, Georgia, which is billing its citizens for eighteen months of trash removal services up front,[230] and the Detroit Public School Authority, which had a cash deficit of as much as $200 million in 2009.[231]

V. CONGRESS'S RESPONSE TO THE MUNICIPAL BOND MARKET PROBLEMS

A. Legislation Enacted

By early 2009, the municipal bond market was still experiencing the problems it had experienced in most of 2008.[232] Congress, with George W. Bush as President, had enacted the Housing and Economic Recovery Act of 2008, which had some effect on the municipal bond market near the end of his term.[233] Though the primary purpose of this Act was to prevent home foreclosures for millions of homeowners by providing them with refinancing choices, the Act did help the municipal bond market slightly by increasing the use of private activity bond proceeds of mortgage revenue bonds.[234] However, the Act did not address the concerns of issuers of governmental bonds who were still experiencing problems with issuing bonds.[235] The municipal bond market's problems were more directly addressed by President Obama and the 111th U.S. Congress. On February 17, 2009, the American Recovery and

230. Heather Darenberg, *1st Fees for Trash Plan Draw Fire*, GWINNETT DAILY POST, June 3, 2010, http://www.gwinnettdailypost.com/home/headlines/95585089.html.

231. Jennifer Mrozowski, *DPS Asks State for $168M Loan*, DETROIT NEWS, Mar. 28, 2009, at A3.

232. See *supra* Part IV for an explanation.

233. *See* Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654 (signed into law on July 30, 2008).

234. *See* I.R.S. Notice 2008-79, 2008-40 I.R.B. 815 (guidance on the Housing and Economic Recovery Act of 2008). The purpose of the Act was to prevent home foreclosures for millions of homeowners over a five-year period and to provide refinancing choices for some of these borrowers. *Id.* The Act accomplished this purpose by modifying mortgage revenue bonds (MRBs), private activity bonds whose proceeds are used to finance owner-occupied residences, under I.R.C. § 143. *Id.* The use of MRBs was expanded to apply to the refinancing of mortgages originally financed by subprime loans; the volume cap for issuing private activity bonds for states was increased to accommodate the expanded MRB program; and the Code was amended to permanently exclude the interest earned on MRBs from a taxpayer's computation of its alternative minimum tax liability. *Id.* The amount of private activity bonds that can be issued in each state is limited to an amount based on that state's population. *Id.*; *see* I.R.C. § 141.

235. See *supra* Part IV for a discussion of the problems with the municipal bond market concerning the postponement of bond issuance due to the increased cost of issuance, higher yields being demanded by investors, instability in the underwriting of municipal bonds, lack of availability of bond insurance, and the challenge by issuers of the integrity of bond rating agencies.

Reinvestment Act, also known as the Stimulus Bill, was signed into law by President Obama on February 17, 2009.[236] The Stimulus Bill was passed to help the U.S. economy recover from the economic recession through government spending and tax cuts, and to help save and create millions of jobs to counter unemployment.[237] The President and Congress also responded to the needs of the municipal bond market by including in the Stimulus Bill the Build America Bond (BAB) program.[238] The purpose of the BAB program was to assist state and local governments in financing capital projects at lower borrowing costs and to promote economic recovery and job creation in states and local communities.[239] An additional purpose was to help stimulate the municipal bond market by attracting new investors that did not seek investments in tax-exempt debt.[240]

B. The BAB Program

The BAB program provides a federal subsidy to state and local governments as an alternative to tax-exempt financing.[241] The federal subsidy provided to state and local governments in tax-exempt financing is accomplished indirectly by providing a tax benefit to the purchasers of the bonds.[242] The subsidies with the BAB program can take the form of refundable tax credits provided to the investor in the bonds (Tax Credit BABs) or refundable tax credits paid directly to the state or local government issuer of the bonds (Direct Payment BABs).[243] The Tax Credit BABs provide a federal subsidy through federal tax credits to investors in the bonds in the amount equal to 35% of the total coupon interest, which results in a federal subsidy to

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236. *See* American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115.

237. *See The Recovery Act*, RECOVERY.GOV, http://www.recovery.gov/About/Pages/The_Act.aspx (last visited May 17, 2011) (providing details on the Act—$288 billion in tax cuts; $224 billion in extended unemployment benefits, education, and health care; and $275 billion for job creation using federal contracts, grants, and loans).

238. *See* American Recovery and Reinvestment Act § 1531(a) (adding a new I.R.C. § 54AA).

239. I.R.S. News Release IR-2009-33 (Apr. 3, 2009) ("These innovative bonds give state and local governments an important new tool to help finance public capital projects that will benefit communities in challenging times. . . .").

240. Robbins & Simonsen, *supra* note 74, at 57. The new type of investor is discussed in more detail in the text below.

241. Dan Seymour, *Munis See 3d Busiest November on Record; Market Nears Another $400 Billion Year*, BOND BUYER, Dec. 1, 2009, at 1, *available at* http://www.bondbuyer.com/issues/118_229/new-issue-volume-november-2009-1004416-1.html.

242. *See* I.R.C. § 103. See *infra* Part III.B for a discussion of tax-exempt versus taxable yield equivalence analysis.

243. *See* I.R.S. Notice 2009-26, 2009-16 I.R.B. 833, 834.

the state or local government issuer of approximately 25% of the total return to the BAB holder.[244] For example, a BAB holder who receives 6% return on her investment receives a tax credit equal to 35% of 6%, or 2.1%. Therefore, on a $100,000 investment that provides $6,000 of interest income a year, the BAB holder receives a tax credit of $2,100.[245] The Direct Payment BABs provide a federal subsidy to state or local government issuers by directly reimbursing the issuer a portion of their borrowing cost equal to 35% of the coupon interest paid to BAB holders.[246] Thus, if an issuer paid a coupon interest rate of 7% on BABs, the federal subsidy would reduce the effective interest rate paid to BAB holders to 4.55%. To receive the payment from the IRS, issuers file a Form 8038-CP, Return for Credit Payments to Issuers of Qualified Bonds.[247] The federal government reimburses the issuer but does not provide a guarantee on the payment of the subsidy.[248] If the issuer does not pay the interest to the BAB holders, the federal government has no obligation to reimburse.[249] To date, no Tax Credit BABs have been issued. It appears that issuers prefer the Direct Payment BABs because the rate of the federal subsidy is higher than that of the Tax Credit BAB.[250]

Both types of BABs provide state and local government issuers with the ability to borrow debt at a lower interest rate, which in turn lowers the cost of the debt service.[251] Both the Tax Credit BABs and the Direct Payment BABs require that the interest on the bond be tax-exempt under I.R.C § 103; that the bond be issued before 2011; and that state and local issuers irrevocably elect to have I.R.C. § 54AA apply.[252] In addition, the proceeds from the bonds must only be used for capital projects.[253]

The BAB program is giving state and local governments access to a different type of investor; an investor that is "tax-indifferent."[254] As discussed

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244. *Id.* The coupon interest rate is the interest rate that a bond issuer will pay to a bondholder.

245. The $2,100 tax credit reduces the BAB holder's tax liability by $2,100. If the tax liability is insufficient to use the entire credit, it can be carried forward to future years. *Id.*

246. *See* I.R.S. News Release, *supra* note 239.

247. *Id.* Issuers can expect to receive the payment forty-five days after the IRS receives the form. *Id.*

248. *See* I.R.S. Notice 2009-26, 2009-16 I.R.B. 833, 834; Robbins & Simonsen, *supra* note 74, at 59.

249. Robbins & Simonsen, *supra* note 74, at 59.

250. *See* I.R.S. Notice 2009-26, 2009-16 I.R.B. 833, 834. The federal subsidy for the issuer is approximately 25% for Tax Credit BABs compared to 35% for Direct Payment BABs. *Id.*

251. *See* I.R.S. News Release, *supra* note 239.

252. I.R.C. § 54AA(d).

253. *Id.*

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

above,[255] most bonds issued by state and local governments are tax-exempt, and the typical purchaser of these bonds is an investor that is sensitive to reducing its taxable income.[256] Investors that buy tax-exempt bonds are high-income investors whose marginal tax rate is at a level that produces a favorable rate of return on tax-exempt bonds versus taxable bonds. The major purchasers of tax-exempt municipal bonds are financial institutions (banks), casualty insurers, investment portfolio managers, and taxpayers in high tax brackets.[257] Investors in taxable bonds are large institutional investors who usually would not buy tax-exempt bonds because they cannot take advantage of tax-exempt interest.[258] "These investors include pension funds, university endowments, foreign investors, life insurance companies, and 401k retirement accounts and others."[259] In addition to the access to new investors, state and local governments like the BAB program because of the substantial cost saving in issuing the debt.[260] In 2009, issuers realized an average decrease in their borrowing costs of .54% with the federal subsidy.[261] The average yield the issuer must pay bondholders in the BAB program is 2.32% while comparable tax-exempt bonds' average yield is 2.86%.[262] The coupon yield that must be paid on the taxable bonds will be higher than that of tax-exempt bonds; however, the cost savings for the issuer of the BABs after the federal subsidy of 35% are substantial.[263] The cost savings are illustrated in the following example: If in spring 2009, the State of California had issued $3 billion of thirty-year BABs and paid an annualized rate of 7.4%, the net rate paid by the state due to the federal subsidy of 35% would be 4.8%.[264] The 4.8% rate is substantially below a 5.65% market interest rate the state would pay on thirty-

255. *See supra* Part III.A.

256. *See* Hume, *supra* note 254, at 5.

257. *See* William J. Darusmont, *Changing Roles of Buyers and Sellers of Municipal Bonds: One Participant's View*, *in* THE HANDBOOK OF MUNICIPAL BONDS, *supra* note 37, at 355, 359–60.

258. Stephen C. Fehr, *Tracking the Recession: Investors Buying up New State-Issued Bonds*, STATELINE (June 8, 2009), http://www.stateline.org/live/details/story?contentId=405287.

259. *Id.*

260. Seymour, *supra* note 241, at 26.

261. William Selway, *Build America Bonds Cut States' Costs, Attract New Buyers, Study Finds*, BLOOMBERG (Sept. 1, 2010, 11:04 AM), http://www.bloomberg.com/news/2010-09-01/build-america-bonds-lure-buyers-after-financing-costs-lowered-study-shows.html; Andrew Ang et al., *Build America Bonds* 10 (Nat'l Bureau of Econ. Research, Working Paper No. 16008, 2010).

262. Ang et al., *supra* note 261, at 7.

263. *See* Seymour, *supra* note 241, at 26.

264. Tom Petruno, *California Municipal-Bond Yields Fall with Advent of U.S.-Backed Build America Bonds on Robust Demand*, L.A. TIMES, Apr. 23, 2009, http://articles.latimes.com/2009/apr/23/business/fi-california-bonds23.

year tax-exempt bonds.[265] The state would have saved over $1.15 billion in interest over thirty years, compared with conventional tax-exempt municipal bonds.[266]

Before the BAB program, taxable bonds only comprised approximately 7% of all state and local bond issuances.[267] The typical taxable bonds are municipal bonds issued for the benefit of a private corporation or entity for which that entity is responsible for payments to bondholders.[268]

From April 2009 to December 2009, $63.4 billion in BABs were issued compared to $332.2 billion in tax-exempt municipal bonds, constituting approximately 16% of all municipal bonds issued.[269] In 2009, BABs accounted for more than 75% of all issuances of taxable bonds.[270] The U.S. Department of Treasury estimates that state and local governments will save $12.3 billion in the net present value of borrowing costs compared with issuing traditional tax-exempt bonds.[271] The State of California has issued seven of the ten largest BAB issuances since the program was enacted.[272]

C. Concerns Regarding the Use of BABs

Critics of BABs state that the subsidy provided by the federal government is too expensive because it exceeds the subsidy provided by tax-exempt

265. *Id.*

266. *Id.*

267. Seymour, *supra* note 241, at 26.

268. *See* Miller, *supra* note 192, § 4:26 (describing taxable bonds); *see also supra* notes 45–52 and accompanying text (discussing private activity bonds and the rules regarding their tax-exemption).

269. *See* Ang et al., *supra* note 261, at 1.

270. Robbins & Simonsen, *supra* note 74, at 55.

271. *See* Press Release, U.S. Dep't of Treas., Treasury Releases New Report on Build America Bonds: Recovery Act Bonds Program Provides More Than $90 Billion Nationally to Date, Estimated to Save State and Local Governments More Than $12 Billion (Apr. 2, 2010), *available at* http://www.treasury.gov/press-center/press-releases/pages/tg625.aspx.

272. Silla Brush, *California Biggest Build America Bonds Player*, THE HILL (Apr. 2, 2010 12:25 PM ET), http://thehill.com/blogs/on-the-money/banking-financial-institutions/90397-california-biggest-build-america-bond-winner. The top 10 issuances are: (1) State of California—highway/recreational/school/water utility improvements—$5 billion; (2) State of California—school improvements—$2.5 billion; (3) State of California—school improvements—$1.75 billion; (4) New Jersey Turnpike—highway improvements—$1.375 billion; (5) Los Angeles Unified School District—school improvement—$1.37 billion; (6) Bay Area Toll Authority—highway improvement—$1.3 billion; (7) Los Angeles Unified School District—school improvements—$1.25 billion; (8) Municipal Electrical Authority of Georgia—electric light & power improvements; refunding notes—$1.224 billion; (9) State of Texas—highway improvements—$1.208 billion; (10) University of California—higher education improvements—$1.022 billion. *Id.*

bonds.[273] At the end of 2009, the federal government estimated an annual subsidy payment to issuers was approximately $1.4 billion, with an estimated $35 billion paid over the life of the bonds.[274] The $1.4 billion is offset by approximately $432 million in taxes collected from investors in BABs, for a net cost to the federal government of approximately $946 million.[275] The federal government will be paying the subsidy to issuers for the life of a BAB, which averages between twenty-six to thirty years but can be as long as forty years.[276] It is difficult to compare the direct subsidy of a BAB with the tax expenditure cost of a traditional tax-exempt bond; however, there is evidence that the 35% subsidy exceeds the traditional benefit of the tax-exempt bond.[277]

Another concern is the high underwriting costs initially being charged to underwrite the BABs, which were comparable to fees charged to underwrite high-rated corporate bonds.[278] However in April 2010, a U.S. Treasury report stated that underwriting costs were becoming more aligned with traditional tax-exempt bonds.[279] Some state issuers are concerned that the federal government would withhold paying the subsidies if the issuer owed the federal government money for programs such as Medicare.[280] In March 2010, the State of Florida cancelled the issuance of $265 million of BABs.[281] Despite this concern, issuers like the State of California continue to issue BABs.[282]

VI. PROPOSAL TO HELP REDUCE THE COST OF ISSUING SHORT-TERM DEBT

The BAB program has been very successful in providing state and local governments with an alternative to traditional tax-exempt bonds to finance capital projects, and the demand for these bonds by both issuers and investors

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273. *See* Robbins & Simonsen, *supra* note 74, at 73; Matthew Craft, *The Build America Boondoggle*, FORBES (Nov. 6, 2009, 5:15 PM ET), http://www.forbes.com/2009/11/06/build-america-bonds-munis-california-markets-bonds-economy-budget.html.

274. Robbins & Simonsen, *supra* note 74, at 64–65.

275. *Id.*

276. *Id.*

277. *Id.*

278. Elana Schor, *Behind Build America Bonds' Popularity, Some Lurking Concerns: Experiment to Subsidize Municipal Investments Draws Skepticism*, WASH. INDEP. (Mar. 29, 2010, 6:00 AM), http://washingtonindependent.com/80724/behind-build-america-bonds-popularity-some-lurking-concerns.

279. Press Release, U.S. Dep't of Treas., *supra* note 271.

280. Tom Petruno, *California Greenlights "Build America" Bond Sale Despite Questions About U.S. Subsidy Payments*, L.A. TIMES, Mar. 22, 2010, http://latimesblogs.latimes.com/money_co/2010/03/california-build-america-bond-muni-sale-.html.

281. Stan Rosenberg, *Florida Suspends "Build America Bonds" Program*, WALL ST. J., Mar. 19, 2010, http://online.wsj.com/article/SB10001424052748704207504575129463080291420.html.

282. Petruno, *supra* note 280.

increased substantially following the program's enactment.[283] Congress has also recognized the program's success, and bills have been proposed to extend the program past its expiration date of December 31, 2010.[284] A bill was proposed July 28, 2010, by House Ways and Means Committee Chairman Sander Levin (D-MI), which would extend the BAB program two years, to expire December 31, 2012.[285] The bill also would reduce the federal subsidy from 35% to 32% in 2011 and to 30% in 2012, and includes provisions to extend subsidies for state employment programs and close tax loopholes for businesses with overseas profits.[286]

The success of the BAB program is reflected in two important aspects: It has reduced the cost of borrowing for the issuer by reducing the interest cost of borrowing, and it has expanded the pool of investors that are interested in municipal bonds by adding investors that do not invest in tax-exempt bonds. The BAB program has not addressed some of the systemic issues with the municipal bond market regarding the availability and stability of bond underwriters and bond insurers and the credibility of the bond credit rating system. Those systemic issues may take years to resolve because of the vested interest of municipal bond participants that would be affected by any proposed change. However, the BAB program has addressed the major detriment that bond issuers faced beginning in 2008 because of the subprime mortgage crisis and the economic recession—the prohibitively high cost to issue bonds for capital projects.

The challenges state and local governments faced issuing debt for capital projects prior to the implementation of the BAB program continue to exist for short-term bond issuances.[287] It is possible that the these problems will be

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283. See *supra* Part V for discussion of the popularity of the program with issuers and investors.

284. After the completion of article but prior to final publication, the BAB progam was allowed to expire through the enactment of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312. (Dec. 17, 2010). The Act extended some provisions from the American Recovery and Reinvestment Act of 2009 but the extensions did not include the BAB program.

285. Investing in American Jobs and Closing Tax Loopholes Act of 2010, H.R. 5893, 111th Cong. § 101 (2010).

286. Peter Schroeder, *Build America Bonds-Senate GOP Bill Wouldn't Extend BABs*, THE BOND BUYER, June 15, 2010, http://www.bondbuyer.com/issues/119_362/senate_gop_bill_wont_extend_babs-1013515-1.html. Since the BAB program expired on December 31, 2010, there have been efforts to revive the program. *See Schiff Introduces Legislation to Extend, Expand Use of Build America Bonds Program*, CONGRESSMAN ADAM SCHIFF (Feb. 16, 2011), http://schiff.house.gov/index.cfm?sectionid=49&itemid=769 (describing Representative Adam Schiff's (D-CA) bill titled Build America Bonds Extension Act of 2011 that would extend the program until the end of 2012 but lower the federal tax credit on interest paid from 35% to 28% and allow the bonds to be used to issue qualified § 501(c)(3) bonds used to fund construction of property owned by nonprofits, such as nonprofit hospitals and universities).

287. *See supra* Part IV.

resolved following the end of the economic recession, but the cash flow problems are still present and continue to detrimentally affect state and local communities. The general public in communities where state and local governments are reducing public safety services to address cash flow deficits may not have the patience to wait for an economic recovery.

Reducing the cost of short-term borrowing for state and local governments can be accomplished by simply amending the BAB program to apply to short-term bond issuances used to finance noncapital purposes. There is support from state and local governments and their advocacy groups to amend the BAB program to continue another two years past December 31, 2010, the date the program expired.[288]

An amendment to the BAB program to apply to short-term bond issuances may encounter opposition from certain members of Congress claiming the cost of the program is a waste of taxpayer money.[289] It is estimated that extending the BAB program two years, as proposed by Representative Sander Levin, would cost $4 billion over ten years.[290] Senate Republicans, led by Senator John Thune of South Dakota, claim the BAB program is another wasteful spending program of the federal government.[291]

An empirical study on the cost of an amended BAB program has not been done to date. However, there is evidence that the subsidy that the federal government pays for tax-exempt financing is more costly than a taxable bond. As discussed in the example demonstrating the equivalence of a tax-exempt interest rate to a taxable interest rate,[292] the taxable bond provides a more efficient subsidy for state and local government issuers. Tax-exemption benefits investors with the highest marginal tax rates. As the marginal rate increases, the subsidy received by the state or local issuer is reduced, and the tax benefit to the investor is increased.[293] However, the Direct Payment BAB provides a direct and easily determinable subsidy to the issuer that is not reduced as the marginal rate of the investor increases.[294]

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288. *See* William Selway, *Build America Bond Program's Impending End Spurs Extension Plea to Senate*, BUS. WK., July 9, 2010, http://www.bloomberg.com/news/2010-07-09/build-america-bond-program-s-impending-end-spurs-extension-plea-to-senate.html.

289. *See* Schroeder, *supra* note 286.

290. *Id.*

291. *See* Press Release, Sen. John Thune, Thune's GOP Tax Extender Alternative Is Paid for, Doesn't Add to Debt, Cuts Taxes (June 10, 2010), http://thune.senate.gov/public/index.cfm?FuseAction=PressReleases.Detail&PressRelease_id=3b86ee99-7e55-4c9f-baeb-6ecf96e0c570&Month=6&Year=2010.

292. See *supra* Part III.A for an example of tax rate equivalence.

293. *See* Robbins & Simonsen, *supra* note 74, at 55.

294. *See supra* Part V.B.

The inefficiency of using tax-exempt financing is demonstrated in the following chart:

AMOUNT	TAXABLE INTEREST RATE	TAX-EXEMPT INTEREST RATE	MARGINAL RATE	FOREGONE REVENUE IN TAXES NOT PAID	SUBSIDY TO ISSUER
5,000,000	4.5%	6%	33%	$99,000	$75,000
5,000,000	4.5%	6%	33%	$75,000	$75,000
TOTAL				$174,000	$150,000

In the above chart, the total federal subsidy for the state or local issuer amounts to $150,000 in interest savings. However, the subsidy costs the federal government $174,000 in foregone tax revenue. The investor with a marginal tax rate of 33% produces foregone tax revenue of $99,000, while the investor with the marginal tax rate of 25% produces foregone tax revenue of $75,000. In both investments, the amount in interest cost savings to the issuer is $75,000. The break-even point for the federal government in this example is a taxpayer with a 25% marginal rate purchasing the bonds. At that point, the amount of the foregone tax revenue of $75,000 equals the interest cost savings to the issuer of $75,000. The federal subsidy from tax exemption is inefficient because investors with marginal tax rates above the break-even point receive a larger subsidy than is necessary to induce the investor to buy the bonds.[295] It is estimated that only 80% of the tax expenditure for municipal bonds is a subsidy to government issuers while the remaining 20% is tax reduction for investors in higher tax brackets.[296] This inefficiency with tax-exempt bonds is estimated to cost the federal government $5 billion annually.[297]

Notwithstanding the issue regarding the cost, an amended BAB program would circumvent many of the cost-of-borrowing issues that state and local issuers confronted in 2008 at the height of the subprime mortgage crisis during the economic recession. Cost reduction of borrowing is greatly needed by state and local governments that are facing reduced collection of revenue due to the recession and drastic budget cuts of essential services to their citizens. In

295. *See* Robbins & Simonsen, *supra* note 74, at 56.

296. *Id.* at 56–57 (citing two studies by the Congressional Budget Office and the Joint Committee on Taxation).

297. *Id.*

addition, the amended program will also help state and local governments attract new investors that are not traditional buyers of tax-exempt bonds. The ability to issue either short-term tax-exempt bonds or BAB short-term bonds would give state and local governments flexibility in financing tools to fund cash flow deficits, which is essential to bringing stability to state and local governments. Of course, the state and local governments have the ability to raise more revenue with the assessment of higher taxes and fees, but that ability is finite and not always politically feasible.

Providing this additional financing tool for state and local governments is not intended to "reward" badly managed or irresponsible operational decisions of elected and appointed officials in charge of running our local governments. The issuer of BABs is still subject to the restrictions of tax-exempt bonds.[298] Therefore, the issuer of BABs has the flexibility of issuing taxable bonds but is not free of the restrictions on tax-exempt bonds.[299] The amended BAB program is a temporary financial tool that will help state and local governments confront the reduction in tax revenue.

VII. CONCLUSION

The subprime mortgage crisis and the economic recession have disrupted the municipal bond market and increased the cost of issuing short-term debt used by state and local governments to fund cash flow deficits. This disruption in lending and borrowing demonstrates the need for state and local governments to have an additional financial tool like the taxable bond instrument in the BAB program to help fund their cash flow deficits. The BAB program utilizes the same restrictions of the tax-exempt bond to prevent abuse of a federal subsidy. The amended BAB program would be a temporary measure used to help resolve the pressing needs of state and local governments that lost much of their tax revenue due to the economic recession. Extending the BAB program to short-term bonds used for financing operations of state and local governments does not reward irresponsible governing or bad financial management decisions of elected or appointed officials. An amended BAB program will provide additional flexibility to state and local governments seeking to address cash flow needs that are not caused by financial

298. I.R.C. § 54AA(d)(1)(A) (requiring that the interest on the bond would be excludable if it were an I.R.C. § 103 tax-exempt bond).

299. *See supra* notes 67–73 and accompanying text (providing the restrictions on tax-exempt bonds including the requirement that the proceeds of the bonds are for a governmental purpose, and the proceeds are not used to acquire higher yielding investments).

mismanagement or political lack of integrity. It will assist state and local governments in achieving their governance obligations to their constituents without cutting essential services like trash collection.