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Taxation Without Premeditation: An Economic Analysis of the Structure, Regulation and Strangulation of the Private Activity Bond Market

Kevin Outterson

Boston University School of Law

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Private Activity Bonds (PABs) are private debt issued under the auspices of state governments. The states issued $119.4 billion dollars of long-term PABs in 1985. Utilizing the state government conduit transforms the bond interest into federally tax exempt income. As a result, PABs bear lower interest rates than comparable taxable bonds. PAB financing significantly reduces private capital costs at the expense of the Federal Treasury.

The structure of the PAB subsidy is fundamentally flawed. State governments subsidize local businesses and investments with PABs, often in competition with sister states. The states receive significant local benefits, but bear no direct costs themselves. They reap where they did not sow.

The Federal government bears all direct costs associated with the PAB subsidy. The estimated tax expenditure exceeds eleven billion dollars per year. As a result, states possess strong economic incentives to expend the federal subsidy by overproducing PABs.

State, local, and federal authorities agree that some form of restrictions on PABs are necessary. Current efforts have largely ignored the fundamental overproduction incentive. Worse yet, many of these ineffective regulations severely encroach upon state and local governmental authority to issue tax-free debt. This Article will examine the current regulatory morass and suggests that almost all federal regulation of PABs could be replaced by a simple participation requirement which would confront the central problem without undue federal interference in state and local government.

* Michael Kevin Outterson (B.S. in Speech (with Honors), Northwestern University 1984; J.D., Northwestern University, 1987; Member of the Illinois Bar, the American Bar Association, Federal Income Tax Section and the Chicago Bar Association, Federal Income Tax Committee). The author practices in the area of federal taxation and is associated with Lord, Bissell & Brook, Chicago. The author gratefully acknowledges the support of Lord, Bissell & Brook in this project.
II. OVERVIEW OF PRIVATE ACTIVITY BONDS

State bond issuing authorities borrow billions of dollars each year to finance governmental operations such as public transportation, education, and other public improvements. The interest from qualified section 103 bonds is excluded from gross income for federal income tax purposes. These bonds are commonly called "tax-exempt." Tax-exempt bonds are sold at rates of interest below the comparable taxable rate. Since interest is the rental cost of capital, issuers of tax-exempt bonds obtain capital at substantially discounted rates. These bonds were originally issued to finance only public projects, but in recent years...

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1 Section 103 grants tax-exempt status to qualified "obligations of a state (or political subdivision)," including the District of Columbia and certain Indian tribes. I.R.C. §§ 103, 7871(c) (1986).


3 A more precise term would be "tax advantaged." Section 103 income is subject to taxation in various circumstances. Interest from certain PABs are a tax preference item for the purposes of the alternative minimum tax. I.R.C. § 57(a)(5). Utilization of PAB financing by a taxpayer limits most ACRS deductions, resulting in greater tax. I.R.C. § 168(g). Interest on debt acquired to carry tax-exempt income is not deductible. I.R.C. § 265(a)(2)(1986). Finally, states and municipalities often tax Section 103 income.

4 To the extent that interest from PABs is excluded from federal gross income, investors will accept a rate of return lower than comparable taxable investments. See D. Bradford, Untangling The Income Tax 244-45(1986). Historically, tax exempt bond rates have averaged 65% to 75% of taxable rates for comparably risky investments, yielding a differential advantage of 35% to 25% for tax exempt bonds. This differential has narrowed recently to 20% to 15%. TEFRA Conference Report, supra, n. 2, at 98; see also n. 20, infra, and sources cited therein.

5 The differential between tax-exempt and taxable rates delivers a subsidy to the PAB user. For an explanation of the differential, see n. 20, infra, and the accompanying text.
their use to subsidize private businesses has grown dramatically. The Internal Revenue Code 1986 (the "Code") denominated the latter as "Private Activity Bonds" (PABs).

III. ECONOMIC ANALYSIS OF A SIMPLIFIED PRIVATE ACTIVITY BOND MARKET

Private Activity Bonds provide tangible benefits to selected businesses, individuals, and investors. This Part will first establish the framework and characteristics peculiar to the PAB market which encourages PAB overproduction. The second section will analyze the effects of these market forces on the pricing and efficiency of tax-exempt bonds as a subsidy conduit. The final section examines and rejects the option of state self-regulation.

A. The Private Activity Bond Market

PAB production increased ninefold in the decade ending 1985, reaching $119.4 billion in that year. Several economic factors contributed to that unprecedented rise. Four primary factors are examined here.

1. State Production of PABs Without Internalized Cost

States produce tax-exempt bonds. The Code grants preferential treatment to certain debt obligations issued under the auspices of a state, a local government or certain Indian tribes. States issue tax-exempt bonds for both public and private purposes. The market incentives for public purpose and private activity bond issuance are markedly different. For public purpose bonds, production is limited by several factors, including the willingness of the government to

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7 The Code defines the technical term "Private Activity Bonds" (PABs) to exclude certain private exempt entity bonds, multi-family housing bonds, and certain bonds for government-owned property. I.R.C. § 141; Clark, "Private Activity Tax-Exempt Bonds, 1984," 5:3 Statistics of Income Bulletin 55, 59 n.2 (Department of the Treasury, Winter 1985-86) [hereinafter, Clark (1986)]. For this Article, the term Private Activity Bonds refers to all industrial development bonds (IDBs), student loan bonds, private exempt entity bonds, qualified mortgage subsidy bonds, and qualified veterans' general obligation bonds, as well as any other bonds used for a private purpose.


9 I.R.C. §§ 103, 141-148, 7871(c) (1986).
incure debt, its ability to repay, and political obstacles such as bond referenda. The state incurs direct economic and political costs for each public bond issued. As a result, the states apply strict public purpose tests upon their issuance of public bonds.

These restraints are absent from PAB production. PABs are produced by states but repaid from private sources. Typically, the lease payments and revenue from the private activity are the sole source of repayment. The government does not guarantee the debt. Underwriting and bond issuing costs are recovered from bond proceeds. In this sense, PABs are produced without direct cost to the bond issuing authority.

PABs produce significant benefits for local communities. States have aggressively marketed PAB financing as a foundation of industrial development incentives. Businesses which invest locally are rewarded with sub-

10 The administrative costs which may be allocated to a PAB are limited by section 147(g). In these situations bond authorities sometimes issue companion "Tax Tails," a small taxable bond issued to cover costs of a tax exempt project. Previously, issuance costs were recovered by investing a portion of the bond proceeds in higher-yielding taxable securities, which are tax-free to a state. See Zimmerman, supra, n. 6, at 10-11 and sources cited therein. These "arbitrage" profits must now be rebated to the federal government. I.R.C. 148.

11 The bond issuing authority experiences no internalized costs because PABs are typically repaid solely from private sources. The authority is not liable for the debt upon default. Zimmerman, supra n. 6, at 9-10.

This Article examines many direct and indirect expenses which result from PAB issuance such as federal tax expenditures, administrative costs and higher tax-exempt financing rates for traditional governmental bonds. These expenses, however, are either borne by the federal government or indirectly by the states. The true cost of PABs are not determined and internalized in the decision making process of a bond issuing authority. The Congressional Budget Office stated: "... these programs appeal strongly to local officials who believe that the programs provide them with an opportunity to give possible benefits to their constituents with no expenditure of local or state tax revenues." Congressional Budget Office, "Tax Exempt Bonds for Single-Family Housing," House of Representatives, 96th Cong., 1st Sess., C.P. 96-2, April 1979, p. 5. [hereinafter Congressional Budget Office, "Tax Exempt Bonds"].


Low cost financing is not the only factor a corporation considers when contemplat-
sidized financing. The business spends bond proceeds on land acquisition, development, and construction. As a result, the local tax base is expanded. New projects also employ more workers, who in turn fuel the economy. In addition, politicians gain favor with grateful business constituencies.

Some studies challenge the efficacy of tax exempt financing as a tool for national economic development.\textsuperscript{13} PABs might merely lure business from one community to another without significantly increasing aggregate savings and hence, aggregate investment. Although this issue is beyond the scope of this Article, one point remains clear: local economies and governments derive significant direct benefits from PABs, albeit often at the expense of other communities.\textsuperscript{14}

The combination of beneficial returns without internalized costs are perilous. Each state has an unlimited incentive to produce as many PABs as possible in order to attract investment, employment, and economic development. All direct costs are paid by the federal government. Without other constraints, states would produce unlimited amounts of PABs.

2. Unlimited Business Demand for the PAB Conduit

When choosing a location for new investment or development, one factor businesses consider is the availability of subsidized financing. The community which offers a PAB is marginally favored.\textsuperscript{15} Capital costs are often a significant portion of development expenditures. A PAB financed business operates with lower capital costs, delivering a competitive advantage vis-à-vis other businesses.\textsuperscript{16}

\textsuperscript{13} See, e.g., Zimmerman, supra, n. 6, at 12 and sources cited therein; Kenyon, "Interjurisdictional Tax and Policy Competition: Good or Bad for the Federal System," (draft submitted to the U.S. Advisory Commission on Intergovernmental Relations, Nov. 9, 1987) [hereinafter, Kenyon (1987)], at 109-112.


Another possibility is that the subsidy has a distributional effect between states. See Zimmerman, supra n. 6 at 14. The current PAB market evidences no deliberate geographic distributional effect.

\textsuperscript{15} See Kenyon, supra n. 13.

\textsuperscript{16} For estimates, see Zimmerman, supra, n. 6 at 14-16 and sources cited therein.
As PAB financing becomes more widely available, however, its value as a unique location incentive declines. Nevertheless, PAB financing will still be cheaper than traditional financing. Standout communities which do not offer PABs will be disfavored.17

Business demand for PABs is constrained only by the demand for capital generally. All other factors being equal, businesses would always choose cheaper capital costs. Theoretically, all capital borrowing needs could be financed through PABs. In addition, lower borrowing costs would increase marginal borrowing. Thus, theoretical demand for PABs exceeds 100% of the capital demand of the market.18

3. Investor Demand and Pricing of Tax Exempt Bonds

Investor demand for tax-exempt income is a function of three factors: the marginal rate of taxation, the interest rate differential between taxable and tax-exempt instruments (the "tax-exempt differential"), and the amount of capital available for investment.

As the marginal rate of taxation increases, tax exempt income yields proportionately greater returns.19 At a 25% marginal tax rate, a PAB with a


18 The potential demand for PABs by businesses varies with the net benefits they receive through PAB financing. If PABs are freely available and costless to businesses, all borrowing needs would be met through less expensive PAB financing. As PAB costs increase, fewer businesses will demand PAB financing. When lower cost financing is obtainable elsewhere for all potential buyers, demand for PABs will cease.

Additional costs to the business include administrative and political expenditures to acquire a PAB, as well as opportunities (such as ACRS depreciation) which must be foregone in order to qualify for certain PABs.

19 The total yield on tax exempt income must account for the equivalent taxable yield of the bond:

\[
\text{Equivalent Taxable Yield} = \frac{\text{Tax Exempt Rate}}{1 - \text{Marginal Tax Rate}}
\]

For example, as the marginal tax rate increases, a 6% PAB yield greater equivalent taxable yields:

<table>
<thead>
<tr>
<th>Tax Exempt Rate</th>
<th>Marginal Tax Rate</th>
<th>Equivalent Taxable Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>.06</td>
<td>0</td>
<td>.06</td>
</tr>
<tr>
<td>.06</td>
<td>.10</td>
<td>.0667</td>
</tr>
<tr>
<td>.06</td>
<td>.25</td>
<td>.08</td>
</tr>
<tr>
<td>.06</td>
<td>.50</td>
<td>.12</td>
</tr>
<tr>
<td>.06</td>
<td>.75</td>
<td>.24</td>
</tr>
</tbody>
</table>
nominal yield of 6% yields an after-tax equivalent yield of 8%. If the marginal tax rate is 50%, the after-tax yield on the same PABs increases to 12%. At a 75% marginal rate, the after-tax equivalent yield is 24%.

A second factor in the pricing of PABs is the tax-exempt differential. The tax-exempt differential compares the rate of return on equally attractive taxable and tax-exempt investments. The tax-exempt differential is expressed mathematically as:

\[
\text{Tax exempt differential} = \frac{\text{taxable rate} - \text{tax exempt rate}}{\text{taxable rate}}
\]

The interplay of market forces determines the actual pricing of PABs. PABs will be sold to rational investors only if they produce after-tax equivalent yields greater than comparable taxable investments. If tax-exempt instruments yield 7%, compared to a 10% taxable yield (30% differential) any taxpayer above a 30% bracket receives an after-tax gain from investing in tax-exempt bonds. As the differential narrows, lower brackets experience marginal gain from investing in tax-exempt income. On the other hand, with a 50% differential only those taxpayers over a 50% bracket would gain from tax-exempt income. Thus, the differential represents the lowest tax bracket which would make a rational investment in PABs.

Finally, investor demand for PABs is limited by the amount of investable surplus held by taxpayers whose bracket equals or exceeds the tax-exempt differential. If the volume of PABs exceeds this demand for tax-exempt income, then the differential must be decreased to attract lower bracket taxpayers and additional high bracket investments.\(^\text{20}\)


For more anecdotal evidence, see House TEFRA Hearings, supra, n. 12, at 1695 (statement of Richard Guthman, Chairman, Finance, Administration, and Intergovernmental Relations Policy Group Committee, National League of Cities) ("What these shrinking spreads [differentials] in interest rates tell us is the demand for tax exempt bonds has fallen relative to other investments . . . Prices on bonds have gone
4. PAB Cost to the Federal Government

Tax-exempt interest is a tax expenditure. Revenue losses for PABs in 1986 were almost $11 billion.\(^{21}\) The exclusion from gross income of the PABs issued in 1985 alone will result in revenue losses of $58 billion over the term down and supplies have increased."); Trends in Municipal Finance Hearings, supra, n. 2, at 5 (statement of Rep. Pickle) (stating that the tax exempt bonds are selling at 85% of the taxable rate today, compared with 65% traditionally); id. at 14 (statement of John Chapotan, Assistant Secretary for Tax Policy, Treasury Department) (excessive use of PABs damages the traditional tax exempt market).

\(^{21}\) For fiscal years 1986-1990, the revenue loss was estimated at $68.5 billion. Congressional Budget Office, Tax Exempt Bonds, supra, n. 11; Staff of the Joint Committee on Taxation, Tax Reform Proposals: Tax Treatment of State and Local Government Bonds, 99th Cong., 1st Sess., 88 (1985) [hereinafter, Tax Reform Proposals]. The estimated 1986 revenue loss from all tax-exempt bonds was $21.0 billion. Zimmerman, supra n. 6, at 2. The simple revenue loss is:

\[
\text{Simple Revenue Loss} = \text{Marginal Rate} \times \text{Equivalent Taxable Rate} \times \text{Principal Amount}
\]

For example, a PAB in the principal amount of $100,000 would yield the following simple revenue losses:

<table>
<thead>
<tr>
<th>Simple Revenue Loss</th>
<th>Marginal Rate</th>
<th>Equivalent Taxable Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1,000</td>
<td>.10</td>
<td>.10</td>
</tr>
<tr>
<td>2,500</td>
<td>.25</td>
<td>.10</td>
</tr>
<tr>
<td>5,000</td>
<td>.50</td>
<td>.10</td>
</tr>
<tr>
<td>7,500</td>
<td>.75</td>
<td>.10</td>
</tr>
</tbody>
</table>

The simple revenue loss is independent of the nominal yield of PABs. The revenue loss is primarily a function of the equivalent taxable rate, the marginal rate of taxation imposed upon the investor, and the amount of PABs outstanding. These values approximate the revenues the government would have received if the capital had been invested in a comparable taxable investment and taxed at the investor's marginal rate.

This simplified analysis ignores changes in investment portfolios and indirect effects upon the economy from PAB investment. Herdershott’s estimates of revenue loss from the issuance of a billion dollars of Mortgage Revenue Bonds is $25 to $30 million, roughly equivalent to a 10% Equivalent Taxable Rate and 25-30% effective rate of taxation. See Hendershott, supra, n. 20, at 30. The Congressional Budget Office estimates $22.5 million. Congressional Budget Office, Tax Exempt Bonds, supra, n. 11. Sophisticated models of revenue loss estimates are discussed by Toder and Neubig, supra, n. 20.

Annual revenue losses understate the true loss on a long-term PAB. Since many tax exempt bonds are held for up to 30 years, the fiscal effect after five years of a nominally prospective repeal would be limited. Toder and Neubig estimate that repeal of all future PABs in 1985 would increase Federal revenue by $3.4 billion in fiscal year 1990. Toder and Neubig, supra, n. 20, at 395.
of the bonds.\textsuperscript{22} This tax expenditure is a federal subsidy to certain investors and investments.\textsuperscript{23}

Although the Federal government bears the direct costs, all production decisions are made by states. States decided the timing, allocation and magnitude of the federal tax expenditure. Not surprisingly, the states spent freely. Part IV of this Article examines the Congressional response.

B. Effects of Overproduction of Private Activity Bonds

As PAB production soared in response to inappropriate economic incentives, several deleterious effects occurred. This next section examines those unanticipated results of rampant PAB growth.

1. Saturation of Investor Demand for Tax Exempt Income

Investor demand for PABs within each tax bracket is limited. If 50\% bracket taxpayers have $30X available for low risk investment, but the supply issued is $60X, then the bonds must be sold at a higher rate and to lower brackets. Selling to lower brackets requires a narrowing of the tax-exempt differential through higher rates.\textsuperscript{24} The cost advantage of PABs is reduced as the supply of tax-exempt income outstrips demand.\textsuperscript{25}

General public purpose obligations are the traditional source of tax-exempt income. Before the expansion of PABs, public purpose bonds dominated the market. As late as 1970, PABs represented a mere 9\% of the tax-exempt market. In 1984, PABs accounted for 62\% of all tax-exempt bonds issued.\textsuperscript{26}

\textsuperscript{22} Clark (1987), supra n. 8, at 44, n. 4. Data prior to the enactment of the information reporting requirements in 1982 is limited. For a discussion of those limitations, see Zimmerman, supra, n. 6, at 3.

\textsuperscript{23} The revenue cost exceeds the value of the effective subsidy. All subsidy delivery mechanisms entail transaction costs and misdeliveries which reduces overall efficiency. The particular efficiency concerns with the delivery of the PAB subsidy are discussed at n. 31-31 infra and accompanying text.

\textsuperscript{24} When the market for PABs includes a mixture of different effective rate taxpayers, the tax exempt rates must be increased to attract the lowest rate taxpayer. In the example in the text, the rates must be raised to the point that the additional bonds are absorbed either by 50\% effective rate taxpayers willing to invest more capital at higher rates or by lower effective rate taxpayers attracted by the higher equivalent taxable yields. In either case, the tax exempt differential is reduced.

\textsuperscript{25} The cost advantage of PABs to the user of the funds is the tax exempt differential. A differential of 30\% represents a 30\% capital discount. As increased supply forces the differential down, the cost advantage and subsidy are decreased.

\textsuperscript{26} For discussions of this increase, see Toder and Neubig, supra n. 20, at 396; see also Location Incentives, supra, n. 12, at 535, n.140. Table 26 provides relevant statistics:
2. Higher Costs of Traditional Government Borrowing

As PABs flooded the market and the differential narrowed, state financial offices found traditional public purpose bonds being crowded out of the market. Higher rates of interest paid on state borrowing increased the cost of vital governmental functions, such as infrastructure improvements and education. This cost was borne by all issuers of tax-exempt bonds, but the cost

<table>
<thead>
<tr>
<th>Table 26</th>
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<tbody>
<tr>
<td><strong>PRODUCTION OF LONG-TERM TAX-EXEMPT BONDS</strong></td>
</tr>
<tr>
<td><strong>(in billions of dollars)</strong></td>
</tr>
<tr>
<td>Private purpose tax exempt bonds</td>
</tr>
<tr>
<td>Public purpose tax exempt bonds</td>
</tr>
<tr>
<td>Total issues</td>
</tr>
<tr>
<td>Percentage of private purpose bonds</td>
</tr>
</tbody>
</table>

a Includes all private activity bonds, including housing bonds (single family mortgage subsidy bonds, multi-family rental housing IDB’s, and veterans’ general obligation bonds), private exempt entity bonds (501(c)(3) organizations), student loan bonds, pollution control IDBs, small-issue IDBs, and other IDBs.

b Includes all public purpose tax exempt bonds.

c Total of (a) and (b). Totals may not add due to rounding.

d Result of (a) divided by (c).

According to data reported by Zimmerman, supra, n. 6, at 2, n.1, the total long-term tax exempt bond volume, including privately-placed small-issue IDBs in 1985 was approximately $218 billion. Using his data, the figures for 1985 would be:

|  | 119.4 | Percentage of |
|  | 98.6 | private purpose |
| —— | —— | —— |
| Total | 218.0 |

Sources: Office of Management and Budget, U.S. Budget (F-4, 1985), Schedule F, Table F-13, p. F-38; Tax Reform Proposals, supra, n. 21, at 60; Clark (1986), supra, n. 7; Clark (1987), supra n. 8 at 43.

27 The National League of Cities acknowledged the failure of local efforts at restricting PAB issuance. Guthman testified that federal "intervention is necessary if we are going to preserve the municipal bond market for public purposes." Senate TEFRA Hearings, supra, n. 12, at 82. Empirical estimates of the increase in tax exempt rates from an additional $1 billion of tax-exempt bonds ranges from 1 basis point (.01%) to 7 basis points. See Peterson, Tuccillo, and Weichler, supra, n. 20. The 1985 volume of PABs thus would increase the tax exempt bond rate by 119 to 836 basis points. See also General Explanations of the Revenue Provisions of the Tax
was not allocable to any particular PAB. The increasing rates were due to systemic overproduction.

3. Decreased Value of PABs As A Location Incentive

As more and more states offered PABs, their distinctive value as a location incentive declined.\(^2^8\) By the late 1970s, PAB financing was available in almost every state.

PABs were still beneficial to businesses—part of the differential was delivered as a subsidy—but since PABs were freely available, the comparative advantage declined. In addition, the narrowing of the tax-exempt differential resulted in an absolute reduction in the effective subsidy per dollar borrowed.\(^2^9\)

Ironically, while states lost PAB financing as a distinctive location incentive, local government costs increased due to higher borrowing costs brought on by rampant PAB overproduction.

4. Increased Cost to the Federal Government

A reduction in the differential does not translate into lower federal tax expenditures for tax exempt bonds. In fact, more revenues are lost. As more PABs are produced and tax exempt interest rates rise, more income is excluded from the federal tax base. The growth of PABs and the resultant narrowing of the tax-exempt differential reduced the value of the subsidy to borrowers, but the absolute amount of income excluded from federal taxation increased. An estimated $13.9 billion in revenues will be lost in 1988.\(^3^0\)

5. Increased Inefficiency of the Subsidy

As the tax-exempt differential narrowed, the subsidy per dollar borrowed was reduced. In addition, the total number of borrowers increased dramatically. The subsidy was spread among more recipients. Finally, the narrow-

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\(^{2^8}\) "[S]ince PABs are nearly universally available, practically for the asking, they have lost their effectiveness as an economic development tool for cities." *House TEFRA Hearings supra*, n. 11, at 83 (statement of Richard Guthman, National League of Cities). By 1984, all fifty states issued PABs. *Clark (1986) supra*, n 7.

\(^{2^9}\) The differential represents the capital discount. As the differential narrows, the subsidy declines as a percentage of the total project expenditures.

\(^{3^0}\) Sophisticated models estimate total revenue cost for PABs in 1988 at $13.9 billion. *Tax Reform Proposals, supra*, n. 21, at 88. For a discussion of the complexities of revenue loss estimates, see *Toder and Neubig, supra*, n. 20. For a discussion of the simplified revenue cost, see n. 21.
ing of the differential made tax-exempt bonds less efficient as a subsidy delivery mechanism.

The cost of the subsidy is the loss in federal revenues due to the exclusion of interest from gross income. The subsidy benefit is the value received by targeted recipients, namely, borrowers experiencing lower financing costs. The rise in PAB volume and the declining differential increase inefficiency in two ways.

First, as the high bracket market for tax-exempt income becomes saturated, PAB producers raise rates in order to attract lower bracket taxpayers and additional higher bracket investment. Higher bracket taxpayers reap a windfall in the difference between the rate paid on those bonds and the rate necessary to equal taxable investments. For example, assume that tax exempt bonds sold at 7% (30% differential with a 10% taxable rate) in order to access the 30% bracket market. A 35% bracket taxpayer would receive a 5% windfall for investing in the tax exempt instrument. A 50% bracket taxpayer would gain 20% over a comparable taxable investment. This profit to the investor represents cost to the federal government which does not reach the intended borrower. A $100,000 PAB costs the government an estimated $3,400 in lost revenue. The borrower saves $1,980 in interest expense.

Only fifty-eight percent of the subsidy in this example was delivered to the targeted recipient. One PAB study estimates that the ratio of total governmental costs to benefits received is 2.19 to 1, a 45.6% efficiency ratio.

A second form of inefficiency stems from the imprecision of the tax-exempt bond as a subsidy mechanism. Congress does not allocate the subsidy. States make the production and allocation decisions. This system is potentially more efficient because local control could ensure allocation of

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31 See supra notes 19-21, 24-26 and accompanying text.
32 A taxable investment of $100,000 yields $10,000 of taxable income at 10%. At a 34% marginal bracket, the tax would be $3,400. An investment of the same $100,000 in a PAB yields $7,000 of tax free income at 7%. The difference is $3,400.
33 The taxable bond issuer pays $10,000 interest on $100,000 borrowed at 10%. Since interest is deductible, the net cost at a 34% marginal rate is $6,600.
34 A tax exempt bond issuer pays $7,000 interest on a $100,000 PAB at 7%. This interest is also deductible, yielding a net cost of $4,620.
35 Federal tax expenditure of $3,400, less $1,980 subsidy received equals $1,420 delivery loss. $1,980 divided by $3,400 yields 58.23%. Even this estimate is generous because some of the savings in borrowing costs received by the private entity actually end up enriching the state. For example, as part of a PAB financed transaction, a state might lease property to the entity at a rate which delivers some of the subsidy to the state. Others invested a portion of the bond proceeds in higher-yielding arbitrage investments. Such arbitrage profits were limited in 1986. I.R.C. § 148.
36 Kenyon, supra, n. 13, at 112-13 and sources cited therein. See also n. 37 infra.
capital to specialized local needs. Without internalized costs, however, bond issuers have no incentive to economize. As PABs proliferated, almost any sophisticated businesses could receive subsidized financing. Fast food franchises, health clubs, bowling alleys, and nightclubs all received PAB financing. As PABs proliferated, the subsidy to state and local governments for designated public purposes became extremely inefficient.

C. State Self-Restraint Is Unworkable

The economic structure of the PAB market made any attempts at state self-restraint untenable. The benefits were large and apparent while the costs seemed to be paid by the federal government. In this atmosphere, few states exhibited restraint.

1. State Incentives Against Self-Restraint

As discussed above, the first states which issued PABs gained significant advantages by subsidizing local businesses and development with federal expenditures. At first, these benefits were received without the disadvantages experienced in later years such as the saturation of the tax-exempt market and the attendant consequences discussed in Section B above. An early case history is Mississippi.

2. In the Beginning: Mississippi

During the Great Depression, industrially-poor Mississippi issued one of the first modern PABs. Mississippi desired to attract industry to bolster the

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37 In 1985, 54% of all Section 103 bonds were PABs. See n 25. The Treasury loses three dollars for every two dollars of benefit received by tax exempt borrowers. Trends in Muncipal Finance Hearings, supra, n. 2. at 14 (testimony of John Chapotan, Assistant Secretary for Tax Policy). Another study estimated the ratio of governmental cost to targetted benefit to be 2.19 to 1. Kenyon, supra, n. 13 at 112-13 and sources cited therein. But see Toder and Neubig, supra n. 20 (The data relied upon by Toder and Neubig is relatively old and might not accurately reflect the increased marginal inefficiency resulting from the tremendous 1985 production). Thus, no more than 67% of the tax expenditure reached tax-exempt borrowers. If we consider the true target subsidy group to be state public purpose projects, then approximately 30% of the tax expenditure reached the intended recipient. The balance was absorbed by private borrowers, investors and the public finance industry.
38 A portion of the lower cost of capital is passed on to private businesses as an incentive to locate and invest in the issuing jurisdiction. Senate Small Issue IDBs, supra, n. 14. (statement of Ronald A. Pearlman, Asst. Sec. for Tax Policy, Treas. Dept.).
depressed economy. PABs were ruled unconstitutional under the Missis-
sippi State Constitution. The operative provision prohibited the use of public
funds for a purely private purpose.40

In response, the Mississippi Legislature redefined “public purpose” to
include the alleviation of unemployment through PABs.41 The Mississippi
Development Commission issued “certificates of public convenience and
necessity” which authorized the PABs. The State purchased land and built
industrial facilities which were then leased to commercial enterprises.42

The Mississippi Supreme Court recognized this legislative determination
of public purpose and approved the statute.43 The success of the Mississippi
Industrial Development Commission was the beginning of the departure
from a traditional public purpose test in the issuance of PABs.

3. Epilogue: Florida

Florida first authorized PABs in 1969,44 the forty-sixth state to do so.45 By
this time, hundreds of millions of dollars of PAB-induced investment had
been attracted to neighboring states.46 The Florida Legislature held hearings

Fordham Note]. After conducting hearings, the Mississippi Legislature determined
that property tax exemptions were inadequate incentives to attract investment. Albritton v. Winona, 181 Miss. 75, 99, 178 So. 799, appeal dismissed 303 U.S. 627
(per curiam, 1938). Also consider the fact that property tax exemptions are a local tax
expenditure, whereas PABs are cost-free to the issuing authority.

40 See Carothers v. Town of Booneville, 169 Miss. 511, 153 So. 670 (1934) (where
$10,000 in bonds designated to build facilities for the Tupelo Garmet Company were
forbidden).

41 The Preamble to the Act of 1936 found that “there exists an acute, economic
emergency” which requires the development of industries to process the natural
resources of Mississippi (such as cotton), thereby increasing employment and reduc-
ing welfare dependency. 1936 Miss. Laws, 1st Ext. Sess., ch. 1, Preamble. The law
itself declared the use of PABs as a tool of industrial development to be “as a matter
of public policy, for the public purposes” of the issuing jurisdiction. 1936 Miss.
Laws, 1st Ext. Sess., ch. 1, § 1(d).


43 Albritton, 181 Miss. 75, 97-99, 109 supra, n. 39 (effectively reversing Carothers,
n. 40 supra). The Mississippi Supreme Court held that “the Legislature did not there
[in Carothers] declare, but has here [in Albritton] declared, a legislative policy based
on social and economic facts which justified the enactment of the statute. That case,
therefore, is clearly distinguishable from the one here.” 181 Miss. at 109.


45 Storage and Gong, The Florida Industrial Development Financing Act’s
Public-Private Investment in Social Engineering, 24. Univ. Fla. L. Rev. 433 n.1
(1972) [hereinafter, Storage and Gong].

46 Storage and Gong, supra, n. 45 at 433 n.2 (“For instance, in 1967 alone,
Alabama attracted $254.6 million in capital investments through issuance of industrial
revenue bonds; Georgia, $92.7 million; Louisianna, $154.9 million; and South
in 1969 to examine the loss sustained by the state's economy from its lack of PAB incentives. The state quickly adopted a constitutional amendment and passed the Industrial Development Act. The amendment exempted PABs from the prohibition on lending of state credit, as long as no state money was actually at risk. The Act determined that private economic development through PABs was a valid "public purpose." PABs were legislatively approved for industrial and manufacturing projects, but not for tourism facilities.

In 1980 the Florida legislature further expanded the term "public purpose" for PABs, and determined that tourism was "vital to Florida's economy and should be financed" with PABs. The courts ceased to enforce the traditional public purpose requirement for PABs, and deferred to legislative declarations.

The final collapse of the public purpose requirement in Florida came in Linscott v. Orange County Industrial Development Authority, which approved of any PAB so long as the legislature found at least an indirect public benefit, even if the private benefit was substantial and predominant. In its

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47 During the 1969 Florida Hearings, the state legislature emphasized the need to compete effectively with neighboring states in attracting development through PAB financing. See Hearings Before the Florida Senate Committee on Reorganization at 9 (March 19, 1969). Commentators urged Florida to join other southern states in competing for business investment and employment with PABs. Tew, Industrial Bond Financing and the Florida Public Purpose Doctrine, 21 Univ. Miami L. Rev. 171, 194 (1966).

48 Fla. Const. art. VII, § 10(c) (amended 1968) (exempting PABs from the Florida Constitutional prohibition on lending of state credit for private purposes).

49 Fla. Stat. § 159 (1969); see Storage and Gong, supra, n. 45 at 433-37. The standard of "public purpose" for the direct expenditure of state funds, such as salaries or general government obligation bonds, remained strict. Only non-recourse obligations, such as PAB's, enjoyed the broader concept of public purpose. The result is a confusing bifurcation of the term "public purpose." See Linscott v. Orange County Industrial Development Authority, 443 So. 2d 97 (Fla. 1983).

50 Fla. Stat. § 159 (1969); State v. Osceola County Industrial Development Authority, 424 So.2d 739 (Fla. 1982).

51 Florida Industrial Development Financing Act (1980). This legislative finding was applied in Florida v. Osceola County Development Authority, 424 So. 2d 739 (Fla. 1982), where a ten million dollar PAB for a Days Inn Motel was approved by the court. See also Florida v. Orange County Industrial Development Authority, 417 So.2d 959, 962 (Fla. 1982).

52 Florida v. Division of Bond Finance, 495 So.2d 183 (Fla. 1986) ("Legislative declarations of public purpose are presumed valid and are considered correct unless patently erroneous.")

53 Linscott, supra, n. 49, 443 So.2d 97.
opinion, the state Supreme Court emphasized that Florida was being injured by the excessive use of PABs in other states and had to improve its competitive position by greatly relaxing public purpose restrictions on PABs.\textsuperscript{54} In 1985, Florida issued over five billion dollars of PABs.\textsuperscript{55}

4. The Failure of State Self-Restraint

State governments responded to the unlimited availability of an indirect, costless federal subsidy to attract business by systematically removing most local restrictions on their use.\textsuperscript{56} Any states such as Florida which attempted to carefully screen bond projects for a traditional public purpose were punished for their vigilence when neighboring states gladly offered the PABs. As the Executive Director of the Municipal Finance Officers' Association testified in the House TEFRA Hearings:

Many of the state and local officials who are members of our Association have tried to restrict small-issue IRBs at the state and local level of government but have come to the conclusion that it is extremely difficult, if not impossible, for any state, or, for that matter, local government to ban or severely restrict IRBs when neighboring communities and states continue to offer them. State legislatures which have attempted to pass IRB restrictions have not been able to overcome this argument. It is our belief that the current small-issue IRB climate leads to negative and unhealthy competition among the states and unless Federal restrictions are adopted, the use of small-issue IRBs will continue unabated.\textsuperscript{57}

The spokesman for the National League of Cities agreed in the Senate TEFRA Hearings:

This is a problem we cannot solve ourselves. Any city or state that acts to restrict IDB issuance places itself at a competitive disadvantage with surrounding jurisdictions. Understandably, no one wants to be the

\textsuperscript{54} See Linscott, supra, n. 49, 443 So.2d at 97, n.1.
\textsuperscript{55} Clark (1987), supra, n. 8, at 50.
\textsuperscript{56} State governments relaxed the rules only for federally subsidized PAB's issued without local risk. Strict rules for public purpose were kept for general obligation bonds secured by state government funds or taxes. See, e.g., Linscott, supra, n. 49, 443 So. 2d 97. In fact, state constitutions in many states would forbid most PAB's if any state money was at risk. Senate TEFRA Hearings, supra, n. 12 at 95-96, 101-02 (statement of Peter Shapiro, National Association of Counties); House TEFRA Hearings, supra, n. 12, at 1717.
\textsuperscript{57} House TEFRA Hearings, supra, n. 12 at 1716 (statement of Donald W. Beatty, Executive Director, Municipal Finance Officers Association [representing 9000 members who are state and local government finance officials, appointed or elected, and public finance specialists]). IRBs are Industrial Revenue Bonds, a subset of PABs.
first to cut back. To say that it can be handled on a state-by-state basis without Federal legislation ignores reality. . . . [N]o state has acted to eliminate abuses or to restrict volume. 58

In sum, states had powerful economic and political incentives to issue as many PABs as possible without significant internalized cost. 59 The states abandoned a public purpose test and began to draw from the common pool of federal subsidy. 60 Some states sought reform, but no single state had any incentive to act unilaterally. Any restraints must be national and uniform and must address the fundamental market incentives which encouraged abuse.

IV. THE FEDERAL REGULATORY RESPONSE

The basic problem facing Congress was that states were overproducing PABs, eager to spend federal subsidies for local benefit. States scrutinized their own expenditures relatively carefully, looking for a valid public purpose. When spending federal money, however, the states were almost reckless.

The federal government responded to the perceived abuse of PABs with a

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58 Senate TEFRA Hearings, supra n. 12 at 83 (statement of Richard Guthman for the National League of Cities). IDBs are Industrial Development Bonds, a subset of PABs.

59 States have no individual incentives to restrict cost-free production of PABs. If state A began PAB restrictions, it would suffer a competitive disadvantage against other states which offered PABs without restriction. State A’s restraint would be unlikely to reduce the supply of PABs enough to lower general tax exempt interest rates. In fact, other states would have an incentive to increase production of PABs to fill the demand left by A’s withdrawal. Representative Rostenkowski (Dem. Ill.), Chairman of the House Ways and Means Committee, opened the House Municipal Finance Hearings with the following observation:

I fully understand the popularity of IDBs at the local level. As long as the indirect subsidies paid for by the Federal government can be given out without any direct cost being borne by the issuing government, there is little or no reason for IDBs to be issues with restraint or with some sense of public purpose priorities.

Trends in Municipal Financing, supra, n. 2 at 3 (opening statement of Chairman Rostenkowski).

Commentators have recognized that bonds which do not directly require expenditures or expose the state to any risk of default (such as PABs) require fewer state level restrictions on their use. See, e.g., Buschman and Gibbons, The Legal Framework for Revenue Bonds, in 2 The Municipal Bond Handbook 99 (1983). [hereinafter, Buschman and Gibbons.]

plethora of hearings, statutes, and regulations. This Part examines those restrictions as qualitative, quantitative, and procedural limitations.

Qualitative limitations include various Congressional attempts to impose a federal "public purpose" test upon state issuance of PABs. Business and investor demand for PABs was reduced through limitations upon the tax benefits accruing from PABs. Most of the early restrictions on PABs were qualitative.

Quantitative limitations are primarily the state based volume caps by which Congress hoped to limit state production of PABs. Volume caps were first introduced in 1980, but gained prominence in 1984.

Finally, Congress imposed various procedural restrictions, intending to induce state government to carefully screen PAB projects. Congress hoped that additional procedural hurdles would reduce the volume of PABs and eradicate unworthy projects. These efforts were an attempt to induce local governments to apply local public purpose requirements.

A. Qualitative Limitations

1. Federal Public Purpose Test

a. Qualified purposes

Beginning with the Revenue and Expenditure Control Act of 1968, Congress restricted PABs to certain qualified purposes. Congress attempted to

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62 Pub. L. No. 90-364. Qualified PABs after the 1986 Tax Reform Act are:
(A) an exempt facility bond,
(B) a qualified mortgage bond,
(C) a qualified veterans' mortgage bond,
(D) a qualified small issue bond,
(E) a qualified student loan bond,
(F) a qualified redevelopment bond,
(G) a qualified 501(c)(3) bond.

A qualified exempt facility bonds must use at least 95% of its proceeds for the following uses:
(1) airports,
(2) docks and wharves,
target the federal tax subsidy towards preferred uses and away from perceived abuses and waste.\textsuperscript{63} As a result, the volume of PABs dropped sharply in 1969.\textsuperscript{64} Generally, the entertainment, recreation, and food service industries are disqualified from PAB tax subsidies. Housing and manufacturing are currently favored.\textsuperscript{65}

Qualitative restrictions are a response to the failure of the states to enforce public purpose requirements on PAB production. A national standard, however, ignores local needs. For example, a determination that tourist facilities do not serve a federally-defined public purpose ignores the local determination by Florida that such facilities do serve a local public purpose.\textsuperscript{66} These distinctions result in billions of dollars of suboptimal capital allocation.\textsuperscript{67} As Assistant Secretary Pearlman noted:

\begin{itemize}
  \item (3) mass commuting facilities,
  \item (4) facilities for the furnishing of water,
  \item (5) sewage facilities,
  \item (6) solid waste disposal facilities,
  \item (7) qualified residential rental property,
  \item (8) facilities for the local furnishing of electrical energy or gas,
  \item (9) local district heating or cooling facilities, or
  \item (10) qualified hazardous waste facilities.
\end{itemize}

I.R.C. § 142(a) (1986).

These terms themselves are defined in section 142(b)-(h). The Tax Reform Act of 1986 disqualified sports, convention, trade show, parking, or pollution control facilities from exempt facility status. \textit{Compare} § 103(b)(4) (1984) with § 142 (1986).

\textsuperscript{63} Senate Small Issue IDB Hearings, supra, n. 14 at 268-69 (statement of Ronald A. Pearlman, Asst. Sec. for Tax Policy, Treas. Dept., calling for better targeted subsidies); Trends in Municipal Finance Hearings, supra, n. 2. at 3 (statement of Committee Chairman Rostenkowski) ("There may be legitimate uses of IDBs, but these either need to be identified more clearly in the Internal Revenue Code, or state and local governments need to issue such bonds under effective volume limits."); Senate TEFRA Report, supra, n. 36 at 169 (criticizing use of PABs for fast food and private recreational facilities and calling for better targeting of the subsidy according to local needs).

\textsuperscript{64} Location Incentives, supra n. 12 at 535, n. 140.

\textsuperscript{65} See supra, n. 63 and infra, n. 73, and accompanying text. For a recent example of the continuing effort to define federal public purpose, see Notice 87-69, 1987-43 I.R.B. 20.

\textsuperscript{66} See supra, n. 44-48 and accompanying text.

\textsuperscript{67} Galper and Toder estimated the revenue loss and capital allocation effects of Housing Mortgage Bonds to be quite significant. They found that total housing stock would increase by 20-30\% of the volume of tax-exempt housing bonds. Galper and Toder, "Modelling Revenue and Allocation Effects of the Use of Tax-Exempt Bonds for Private Purposes," in \textit{Efficiency in the Municipal Bond Market: The Use of Tax-Exempt Financing for "Private" Purposes} 85, 110.
[PABs] have anti-competitive and distortive effects on the economy. Activities receiving tax-exempt financing have a significant advantage over their competitors, who must raise capital with higher-cost taxable obligations. Yet, the availability of tax-exempt financing for non-governmental persons depends upon which jurisdictions have the necessary programs in place and upon the ability of persons to navigate the various legal and regulatory procedures of state and local law. These factors have little relation to the value or efficiency of particular activities and ought not to influence the allocation of capital among sectors of the economy.  

In addition, the attempt by Congress to specify qualified and non-qualified purposes became a Promethian task. Congress altered the definitions constantly in an attempt to stem the revenue loss. The attempt to fashion a federal public purpose requirement is now regarded as extremely cumbersome and inefficient.

b. The small issues exemption

Qualitative restrictions originally did not apply to small issues, generally any PAB under ten million dollars. The small issue exemption did not discriminate based upon project type. Any small issues qualified under Section 103. Nevertheless, misallocations resulted. As Assistant Secretary Perlman pointed out, businesses had unequal access to PABs. Some small businesses never knew they could take advantage of PABs. National retailers such as K-Mart used this informational disparity in competition against local businesses without PAB financing. Businesses faced a learning curve in utilizing PABs and national retailers enjoyed a considerable advantage.

In addition, the ten million dollar small issue exception itself favored smaller, labor intensive projects over larger, capital intensive ones. Projects that would be more efficient if done on a larger scale of operations were encouraged to split into smaller units, perhaps in different jurisdictions, in order to gain PAB financing.

69 See Zimmerman, supra, n. 6, at 17-12.
70 I.R.C. § 144 (1986).
71 Senate Small Issue IDB Hearings, supra, n. 14 at 268 (statement of Ronald A. Pearlman, Asst. Sec. for Tax Policy, Treas. Dept.).
72 The provisions of the "umbrella" rule in Revenue Ruling 81-216, 1981-2 C.B. 21 and Proposed Treasury Regulation section 1.103-7(b)(6), treated multiple lots of related small issues as a single issue for the purpose of the $10 million ceiling. Funding of larger projects through multiple small issues was prohibited. This rule is now found in section 144(a)(9) (added in 1984 as section 103(b)(6)(P)).
In TEFRA, Congress integrated qualitative restrictions within the small issue exemption, reintroducing the market misallocations that characterized the general PAB market. The small issue exemption lapses for most bonds issued after 1986. The sunset date for small issue manufacturing facilities was recently extended to 1988.

c. Volume caps

One restriction adopted by Congress was state volume caps on various categories of PABs. Volume caps generally will be discussed as a quantitative restriction in Section B, paragraph 1 below. Congress introduced a qualitative dimension however, by establishing separate volume caps for distinct classes of PABs.

Class based volume caps misallocate the available subsidies between end users. Within each special purpose volume cap, market forces might operate to allocate the subsidies efficiently. But in the market as a whole, volume caps are inefficient. Each state will probably utilize its subsidy in, for example, Veterans' Housing Bonds, even if the need for pollution control is more pressing, because the subsidy for Veterans' Housing Bonds is available while the pollution control bonds are not. Unless Congress perfectly allocates the volume caps between the classes (and to each state within each class), volume caps are an inefficient means of delivering the desired subsidy.

2. Reducing Business Demand for PAB Financing

Prior to 1986, the Accelerated Cost Recovery System (ACRS) was a powerful tax incentive for business investment. Some businesses financed

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73 Qualified small issue PABs could not use more than 25% of their proceeds to provide retail food and beverage service, automobile sales or service, or the provision of recreation or entertainment. The issue is disqualified if any portion provides for any private or commercial golf course, country club, massage parlor, tennis club, skating facility (including roller skating, skateboard, and ice skates), racquet sports facility (including handball or racquetball courts), hot tub facility, suntan facility, or racetrack. I.R.C. § 103(b)(6)(o) (added in 1982). In addition, no exempt activity, industrial park, or small issue bond could be used to finance any airplane, skybox, or other private luxury box, any health club facility, any facility primarily used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises. I.R.C. § 103(b)(18) (added in 1984).


76 If the state volume cap effectively reduces the supply of that class of PABs, the demand for that class of PABs could develop into a market for the available subsidy.

77 Since allocations were fixed by class and could not be moved between states and classes, one state's "excess" (allocations beyond optimal levels) could not be used to offset another state's "deficit."

this tax-preferred investment through PABs. Congress perceived this accumulation of tax benefits as abusive.\textsuperscript{79} In TEFRA, Congress required that businesses choose between ACRS deductions and PAB financing. Generally, a PAB financed facility must depreciate on a straight line basis rather than by the ACRS method.\textsuperscript{80} This rule reduced the benefit of PAB financing to businesses.\textsuperscript{81}

In a regime of effective quantitative control over the total volume of PABs (as discussed in Section B, paragraph 1 \textit{infra}) a reduction in the benefits of PAB financing to ACRS qualified businesses would merely shift the PAB to enterprises unable or unwilling to use faster depreciation.\textsuperscript{82} Total volume of PABs would remain the same, with the subsidy shifted to projects which were initially denied a PAB allocation. With total volume of PABs remaining unchanged under the volume cap, the Treasury experiences no net gain, while the economic benefits of the subsidy are directed to less worthy projects.\textsuperscript{83} At best, qualitative controls of this sort are a poor substitute for direct volume caps or responsible local issuance of PABs.

3. Reducing Investor Demand for PABs

A third strategy of qualitative restriction limits the value of PABs to bond holders. These restrictions include disallowal of interest deduction for debt used to acquire tax-exempt income\textsuperscript{84} and tax preference treatment of new PAB income under the alternative minimum tax.\textsuperscript{85} These provisions reduce demand for tax-exempt bonds, either by treating PAB income as taxable for

\textsuperscript{79} See Senate TEFRA Hearings, \textit{supra}, n. 12, at 87.

\textsuperscript{80} I.R.C. § 168(g). Three of the four exceptions to the originally enacted rule were eliminated in the 1984 amendments. See Tax Reform Proposals, \textit{supra}, n. 21, at 35.

\textsuperscript{81} For a statistical analysis of the reduced benefits to businesses under this position, see Zimmerman, \textit{supra} n. 6, at 24-26.

\textsuperscript{82} Assuming that volume caps were effectively reducing the PAB supply well below demand levels, a small reduction in demand through changes in the ACRS rules would not lower overall volume of PABs. To the extent that volume caps were set at levels well above current demand, such quantitative restrictions would lower both PAB supply and demand.

\textsuperscript{83} For example, two $1 million projects apply for PAB financing: A and B. A is qualified for ACRS while B is not. Government X has been allocated one million dollars under its section 146 volume cap. Pursuant to the regulations, local hearings and procedures are followed to determine which project would most benefit the public good. A must choose between tax benefits. If the developers of project A derive more benefit from the PAB, A will take the PAB and B will not be subsidized. If ACRS deductions are marginally more beneficial to A, the PAB will go to B. Without the combined tax benefits, some projects like A will not be built. If A choses to forego the PAB, the subsidy is shifted to less efficient projects.

\textsuperscript{84} I.R.C. § 265(2) (1986).

\textsuperscript{85} I.R.C. § 57(a)(5) (1986).
some purposes or by limiting deductions associated with PAB income. High bracket taxpayers are especially vulnerable to the alternative minimum tax and lose more income when deductions are disallowed.\(^8^6\) As long as buyer demand is lessened by these provisions, tax-exempt interest rates will rise, adjusting to sell the supply in a depressed market. In addition, as high bracket taxpayers reduce their total holdings, lower bracket taxpayers will hold a greater percentage of PABs. Lower bracket taxpayers require greater nominal interest rate returns on tax-exempt income than higher bracket taxpayers.\(^8^7\) Together, these factors will narrow the differential between taxable and tax-exempt bonds, with all of the negative consequences discussed in Part II above. These strategies actually increase the inefficiency of the subsidy.

4. Internalizing the Cost of PABs to the Bond Issuing Authorities

The Treasury proposed a fourth type of qualitative restriction which was considered, and rejected, in TEFRA. The root of PAB overproduction and misallocation is the separation of production decisions and revenue (made by states) from expenses (paid by the federal Treasury). The actual costs and benefits of the PAB must be internalized in the decision making process of the producer. Currently, only the benefits are internalized to the producer.

Under the "matching fund" proposal, the issuing state or local government must directly participate in a percentage of the financing. Required participation would place some costs of production directly upon state and local governments.\(^8^8\) PAB productions and consumption decisions would be made with some local money at stake. Some production costs would be internalized. Treasury understood that issuers would be much more prudent with their own money.\(^8^9\) States would subject PABs to the same scrutiny

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\(^8^6\) High bracket taxpayers are more likely to use the tax preferences which would trigger the alternative minimum tax (AMT). Adjusted gross incomes under $40,000 are excluded from AMT. Interest deductions are more valuable to higher bracket taxpayers, who will receive a greater tax savings per deduction dollar than lower bracket taxpayers. In addition, reduced leverage opportunities will reduce the total volume of PABs which high bracket taxpayers are able to hold since they can borrow less when the interest is no longer deductible. All of these factors combine to reduce demand for PABs among high bracket taxpayers.

\(^8^7\) See supra, n. 19, 20, and accompanying text.

\(^8^8\) Required participation could take the form of direct expenditure of public funds or requiring the state to guarantee repayment from its tax base. Prior financial responsibility provisions have allowed repayment solely from the project's revenues. See Zimmerman, supra, n. 6, at 22-23. The public treasury of the state must be at risk in order to offer an appropriate incentive.

\(^8^9\) See Senate TEFRA Hearings, supra, n. 12, at 88,95; House TEFRA Hearings, supra, n. 12, at 1303, 1699, 1717, 1762, 2030.
given to direct expenditure of public funds. States would now have an economic incentive to carefully screen and monitor projects. Overproduction of PABs would decline and the remaining PABs would be allocated more efficiently.

Opposition in Congress overwhelmed this excellent proposal. At least twenty state constitutions forbid the expenditure or lending of state funds for private purposes. Required state participation would make PABs unconstitutional in most states. Constitutions would have to be amended to allow PAB financing to continue. Other states would have to alter statutes and judicial doctrines which restrict the private use of public credit. Congress balked at such a sweeping change in the PAB landscape.

The disparity between state issuance of public purpose bonds and PABs is precisely the problem. The abuses of PABs have resulted from the lack of state incentives to carefully produce and allocate PABs. Congress should not be surprised that a participation requirement necessitates local changes. Those changes, in fact, are the goal of this restriction. Mandatory financial participation would induce more responsible local decision making. The level of required participation could be varied to carefully tailor the power of the incentive. This approach would avoid the violence that the tax-exempt market has suffered at the hands of Congress.

Opponents of the proposal complained about federal intrusiveness requiring major constitutional or statutory change in all fifty states. Most states currently do not allow public credit to support private projects. Actually, the federal government does not force the states to issue PABs. Perhaps PABs are, like other tax deductions, a matter of legislative grace. States could

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90 Senate TEFRA Hearings, supra, n. 12, at 88.
91 House TEFRA Hearings, supra, n. 12, at 1717, 1762. The fact that constitutional and statutory law in most states prohibits granting of subsidies to private businesses out of state funds clearly suggests that the projects are not in the public interest. The states consider these projects to be in the public interest only if federal, rather than state, funds are used.
92 House TEFRA Hearings, supra, n. 12, at 1717.
93 Id.; see also 64 Am. Jur. 2d, Public Securities and Obligations, §§ 124-130.
94 For example if a 2% requirement proved too small to induce the desired level of local responsibility, a 5% requirement could be substituted instead. An uniform required percentage may prove too harsh for economically depressed states. If so, the percentage could be reduced to tailor the subsidy to certain targeted areas.
95 The tax-exempt market endured tremendous gyrations as 1985 ended due to uncertainty about pending congressional restrictions. See Clark (1987), supra n. 8 at 45.
96 Most modern commentators argue that the Constitution does not prohibit federal taxation of state and local bonds, especially of PABs which are not actually obligations of the state. See, e.g., Rotunda, Intergovernmental Tax Immunity and Tax Free Municipals After Garcia, 57 U. COLO. L. REV. 849 (1986). As this Article went to press, the Supreme Court had recently affirmed the constitutionality of the
continue to issue traditional governmental function obligations. State law would be violated only if the state directed the joint state and federal subsidy to a private business. In addition, states are still free to directly subsidize private businesses with their own funds.

Contrary to the allegations made in Congress, a mandatory participation requirement would reduce federal interference by eliminating the need for intrusive federal public purpose restrictions (indeed, all other federal restrictions on PAB financing) since the states would have an incentive to apply their local restrictions. Instead of a broad, inflexible federal standard, each individual state could spend its own money for economic development, matched by federal tax subsidies through the PAB. The clutter of federal PAB regulations could be completely replaced by a simple participation requirement.

A second method of internalizing costs to the state producer of PABs would require the state to match the federal tax expenditure with a tax expenditure of its own. For example, a PAB issued in Illinois is normally tax-exempt under Illinois state income tax as well. This provision would circumvent the state constitutional limitations upon the lending of public credit while requiring a tax expenditure by the state producer. The power of the incentive would be lost, however, in states without an income tax, and would vary between states according to their rates of taxation and other factors.97

B. Quantitative Limitations

A second type of limitation has been the focus of Congress since 1984. While enacting quantitative restrictions, Congress left the earlier qualitative limits in place. The following sections examine the quantitative limitations, primarily volume caps on PAB production.

1. Volume Caps

The most prominent forms of quantitative restrictions are the volume caps imposed by Congress on various classes of PABs.98 Volume caps on specific

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Section 103 bond registration requirement in *South Carolina v. Baker* (No. 94 Orig.) (decided April 20, 1988).

97 Arguably, this incentive is already in place in most states. The power of the incentive is lost due to several factors. First, most PABs are sold in the national market to out of state purchasers, effectively reducing the state tax expenditure to zero. Second, the indirect nature of the PAB tax expenditure is unlikely to attract close scrutiny by state officials. Finally, since the gross revenue cost of a PAB is a function of the state’s marginal rate of taxation, the power of the incentive varies widely across the nation.

98 Prior to the Tax Reform Act of 1986, three separate volume caps were applied to:

(1) IDBs and student loan bonds, I.R.C. § 103(n)(7);
(2) qualified veterans' mortgage bonds, I.R.C. § 103A(o)(3);
(3) qualified mortgage bonds, I.R.C. § 103A(g)(4).
categories of bonds date back to 1980. Several additional caps were enacted in 1984. In the Tax Reform Act of 1986, Congress gathered several independent provisions into one unified cap. The Treasury determines a certain dollar volume of PABs which each state may issue. Year to year carryovers are limited, and transfer of allocations between states is forbidden. Allocations are based on population, with a floor amount for the least populous states.

This proposal faced opposition in Congress, especially from large states such as New York which would have to reduce issuance of PABs under the cap. As a concession to gain acceptance, Congress phased in the alloca-

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101 IDBs (including most exempt facility and small issue bonds), qualified student loan bonds, qualified redevelopment bonds, and qualified mortgage bonds were placed into an unified volume cap. I.R.C. § 146(g). Qualified veterans' mortgage bonds (available in only five states) remain subject to their historic separate caps. Certain government-owned airport, dock, and wharf facilities, 501(c)(3) organizations and qualified refunding issues are exempt from the unified volume cap. I.R.C. § 146(g). No single private party may receive more than $40 million in small issue bonds. I.R.C. § 144(a)(10). Non-hospital 501(c)(3) organizations may receive no more than $150 million in PABs. I.R.C. § 145. The only 501(c)(3) organizations in Illinois currently constrained by this last provision are Northwestern University and the University of Chicago. Currently, neither may receive additional PABs directly. Their medical facilities are considered outside of the 501(c)(3) cap.
102 Rev. Proc. 84-85, 1984-2 C.B. 785. Volume caps for subsequent years have not been issued.
103 Specific projects must be identified for a carryover that cannot exceed three years. I.R.C. § 146(f) (1986).
105 The volume caps for each state are equal to the greater of the following amounts:

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<th>Under TRA 1986</th>
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The TRA of 1986 increased the floor amount by 25% to $250 million until 1988, when it drops to $150 million, just 25% below the original level set in 1984. During the same time period, the per capita amount has fallen 66% from $150 to $50. This scheme increasingly favors smaller states.
106 Sen. D'Amato, N.Y., was particularly hostile to limitations upon PABs. See Senate Small Issue IDB Hearings, supra, n. 14, at 277. New York is the center of the public finance industry and would be adversely affected by a contraction of PAB volume.
tions at levels well above current production, ensuring that no state would be affected by the cap in the near future.\textsuperscript{107}

Beginning in 1988, however, the per capita allocations are automatically cut by 25\% (from $75 to $50) while the floor amounts drop 40\% (from $250 million per state to $150 million).\textsuperscript{108} With these reductions, several states should exceed their allocations under current trends.\textsuperscript{109} The demand within such states for PAB financing will exceed the supply. Some states will be induced to carefully allocate this scarce good to the most productive user. A state should "sell" the PAB to the buyer which pays the highest social return. Issuing authorities should apply some public purpose requirement to guide their allocation.\textsuperscript{110} This standard would be locally derived and enforced.

Conceivably, a local issuer could grant its limited allocation randomly, or based upon non-efficient criteria such as bribes or favoritism.\textsuperscript{111} PAB procedural requirements (both state and federal requirements for notice, public hearings, and approval by an elected public official) may expose such practices, and should subject the project to greater dialectical scrutiny, as discussed in Section C infra. As competition for the remaining PABs intensifies, such pressure will heighten.

\textsuperscript{107} In 1984 the aggregate national limit was $36.6 billion while production was only $16.4 billion. Rev. Proc. 84-85, 1984-2 C.B. 785. Similar effect was achieved in the Strategic Arms Limitation Agreement, which established arms control "limits" above current levels. In fact, the "limits" encouraged each party to produce weapons up to the limit. In our context, states were encouraged to quickly issue bonds up to the maximum amount. The dramatic reductions occurring after 1984 are akin to the Intermediate Nuclear Forces agreement recently signed by President Reagan and General Secretary Gorbachev.

\textsuperscript{108} I.R.C. § 146(d)(2).

\textsuperscript{109} For example, New York's 1985 volume of PABs subject to the expanded volume caps was $4.32 billion. See Clark (1987), supra, n. 8. Using the figures found in Revenue Procedure 84-85, 1984-2 C.B. 786, New York's volume cap after 1987 will be $882.9 million. New York's production of PABs will be dramatically reduced. As of this writing, Revenue Procedure 84-85 has not yet been updated.

\textsuperscript{110} Trends in Municipal Finance Hearings, supra, n. 2 at 51 (Congressional Budget Office Report) (effective volume limits for PABs "would permit the States to decide for themselves how to allocate subsidies among housing, health care, and private industrial and commercial facilities.")

Volume caps are problematic for several reasons. Initially, the caps are inefficient between states. Unless economic need for PABs exactly correlates with population (and population growth), the subsidy will not be allocated efficiently.\textsuperscript{112} For example, State A in the Rust Belt may be overwhelmed with excellent projects seeking PAB financing. Some highly efficient projects may be denied. State B, on the other hand, is blessed with a vibrant economy and has a generous allocation compared to local needs. With no incentive not to use the entire allocation (and unable to transfer part of the allocation to State A), State B will issue PABs for spurious projects while vital needs in State A are neglected. A national allocation system for PAB production and consumption could be established. PABs could be allocated to the most efficient projects throughout the nation. A market mechanism for this system would require a form of open trading in PAB rights among issuers.\textsuperscript{113} Regulatory allocation would require administrative determinations of public purpose and efficiency for myriads of local projects. A hypothetical National Industrial Development Authority would encounter problems similar to direct grant programs. In the end, Congress chose simple production quotas, based upon population with floor allocations for small states.

A second difficulty with volume caps parallels the first. States must divide the available allocation of PABs between their various political subdivisions such as cities, counties, Industrial Development Authorities, and state agencies. Procedural restrictions govern allocation between jurisdictions within a state. Since the need for economic development may vary remarkably between different regions within a state, allocations based solely upon population might be inefficient. State legislatures may be able to efficiently allocate the PABs if they overlook population based allocations and focus on the relative merits of particular projects or the needs of individual localities. In any case, Congress established a federal interim allocation which interferes in the relationship between each state and its political subdivisions. The federal interim allocation divides the cap equally between the central state government and local governments within the state.\textsuperscript{114} Although the gover-

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\textsuperscript{112} Some of the fastest growing states may have the least need for subsidies designed to attract new business and employment. In a subsidy based upon population, the declining "Rust Belt" states will receive less as time goes on, negatively correlating need with the subsidy.

\textsuperscript{113} If states were allowed to market their rights to issue PABs, a more efficient allocation could develop. However, the market would still be artificial, based upon federally-set state allotments, instead of actual need. Currently, such trading is forbidden. I.R.C. § 146(k) (1986).

\textsuperscript{114} I.R.C. § 146(b)-(c). In Illinois, constitutional home rule units receive 100% of their per capita allocation, instead of splitting their allocation with the central state government. I.R.C. § 146(d)(3).
\end{flushleft}
nor and the state legislature may change this arrangement, the interim allocation operates as a de-facto standard, directly intruding in state and local government relations.

Third, even if the allocation is efficient within some states, in others the volume cap is still set at levels well above optimal or actual demand. In such states, the volume cap is ineffective. The amount of the volume cap itself is arbitrary. The national volume cap (representing the aggregation of the state caps) does not reflect any market determination of need. By setting the cap high, Congress locked in billions of dollars of inefficient projects. Automatically declining caps—plummeting by a sharp 25% in 1988—may be a dramatic shock to the market, but do not themselves ensure an efficient level of subsidy.

2. Enterprise Volume Restrictions

A second, more limited, form of quantitative restriction of PABs limits the amount of PAB financing that any one business may receive through the small issue exemption. The "K-Mart Rule" responds to aggressive use of PAB financing by national retailers. The rule prohibits one corporation from receiving more than $40 million nationwide in small-issue PAB financing. PAB issuers are required to report the names of the beneficiaries of PABs to the IRS to aid in the enforcement of this rule.

This rule lacks any consistent rationale. If a particular project is efficient and advances the public good in one locality, it should be built. The ability of a corporation to serve the public interest in several states simultaneously should not result in a penalty. In its effort to stop the most visible offenders, Congress overreacted with an inefficient rule.

C. Procedural Restrictions

State and Federal procedural restrictions govern how PABs are issued. Every state established procedures for the issuance of tax exempt bonds, often with special provisions for PABs. Generally, states require the approval of the relevant Industrial Development Authority, city, county, or

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115 I.R.C. § 146(e). Again, Illinois constitutional home rule units received a special rule which prevents the state government from changing the allocation of a constitutional home rule unit (such as Chicago) without the unit's permission. I.R.C. § 146(e)(3). The Chairman of the House Ways and Means Committee, Representative Rostenkowski, represents Chicago.

116 I.R.C. § 144(a)(10).

117 I.R.C. § 149(e).

state agency, sometimes with published notice and public hearings. These procedures vary from state to state and between jurisdictions within states. Procedural requirements for PABs are generally less stringent than for government obligation financing which requires repayment from government funds. Since the PAB is a federal tax expenditure, the state has no economic incentive to restrict production through stringent approval procedures.

In its desire to protect the federal revenue, Congress has enacted a myriad of procedural rules which must be followed by the issuer of a PAB.

1. Federal Standards for Local Bond Issuance Procedures

The Code requires local published notice and public approval of all PABs. The government units which host or issue PABs must approve the issue. An elected representative of each government body must approve the issue after a public hearing following reasonable public notice. Alternatively, a voter referendum may be used. This provision does not simply duplicate local procedures for approval of PABs. Rather, the federal government is supplanting local bond finance procedures with additional requirements of its own. Since one of the original rationales for the tax exemption of state bond interest was a promotion of local autonomy with reduced federal interference, these new restrictions should be examined with scepticism.

a. Public notice and public hearings

The notice and hearings requirement were added in the Deficit Reduction Act of 1984 as Section 103(k). The Code simply requires approval “after a public hearing following reasonable public notice” or a voter referendum. Most local statutes require some sort of public notice and hear-

120 Zimmerman, supra n. 6, at 11; See also 64 Am. Jur. 2d, Public Securities and Obligations, § 135; see, e.g., Linscott, supra, n. 49, 443 So. 2d 97 (Fla. 1983).
121 Section 147(f) requires approval by both the issuer and the host of the PAB. The issuer is the government unit with the authority to issue the PAB. The host has jurisdiction over the actual site of the project. In many cases, these will be the same jurisdiction.
123 Under the 1986 reshuffling of the Code, the provisions appear in section 147(f). The 1986 version is identical to the original 1984 amendments with the exception of a new special rule for approval of airport PABs in section 147(f)(3).
125 Id. A voter referendum is difficult and expensive compared to approval by an Industrial Development Authority and is unlikely to be chosen unless already required by local law. See Hester, Industrial Developments and Finance, 19 GEO. ST. BAR J. 84, 86 n.8 (1982). In the November 1982 elections, 178 PAB issues, totalling
ing, but in states that do not, one is now federally required. Temporary Treasury Regulations now define the scope of the federal requirements.

Notice must be "reasonably designed to inform residents" in the host and issuer jurisdictions about the PAB. The regulations define the content of the notice and the timing is presumed reasonable if published no fewer than 14 days before the hearing. In issuer jurisdictions, state or local law controls the adequacy of public notice. In host jurisdictions, state and local law is disregarded. The scope of the notice is presumed adequate only if published in one or more general circulation newspapers in the locality or broadcast over local radio or television. In a jurisdiction which is both a host and an issuer, presumably both standards must be met.

Once reasonable notice has been given, a public hearing takes place. Once again, the regulations specify requirements that are often at variance with local law. Adequacy of the public hearing is determined by the federal standard "without regard" to local law. The regulations address three aspects of the hearings.

The location of the hearings must be convenient to the residents of the approving government units. A hearing in the capital or seat of government of the approving unit is deemed convenient. If several units must approve the PAB, the hearings may be combined into one hearing if the location is no further than 100 miles from the seat of government of each participating unit.

$3.7 billion, were approved by voters. New York Times, Nov. 4, 1982, at sec. IV, p. 12, col. 4. Since total PAB volume for 1982 was $49.6 billion, Table 26, supra, n. 26, only 7.5% of the total PAB volume was submitted to a voter referendum.

Of course the state could issue bonds that ignore the federal tax requirements. Such bonds would be taxable, making them more expensive.

The Temporary Treasury Regulations are based on the 1954 Code, as amended in 1984. The operative sections were reshuffled in the Tax Reform Act of 1986, but remained substantially unchanged. Section 103(k) was moved to section 147(f). Thus, these Temporary Regulations remain valid authority.

Notice must include a description of the facility, maximum value of the bond, owner/operator of the facility, and the location of the project, and the time and place of the hearing. Temp. Treas. Reg. § 5f.103-2(f)(2), (g)(3). If any of the information required is unknown at the time of notice or approval, then the procedure is not qualified under section 147. Temp. Treas. Reg. § 5f.103-2(f)(2)(iv).

The regulations do not make this clear.

Adequacy of approval for the purposes of section 147 is determined "without regard to the authority under state or local law for the acts constituting such approval." Temp. Treas. Reg. § 5f.103-2(d)(2).


The conduct of the hearing is generally left to local custom, as long as interested individuals may express views orally and in writing with reasonable limitations. State public hearing procedures may, but do not have to be, followed.

The elected representative of the governmental unit must approve the PAB, but does not actually have to attend the hearing. Presumably, any designate of such official may conduct the hearing.

b. Approval by the elected representative of the governmental unit

Section 147 requires approval by the “applicable elected representative” of both the issuing and host jurisdictions. The representative may be either the legislative body or the chief elected executive or legal officer. An appointed State Attorney General, for example, would not qualify, even if a state statute specifically granted him the authority to approve PABs. Most Industrial Bond Authority Directors are appointed, and are thus ineligible to approve PABs after 1984. The chief elected representative elected at large in the jurisdiction, or his “elected at large designate,”

137 Temp. Treas. Reg. § 5f.103-2(g)(2) ("[C]ompliance with such State procedural requirements (except those at variance with a specific requirement set forth in this section) will generally assure that the hearing satisfies the requirements of this section.")

138 Temp. Treas. Reg. § 5f.103-2(g)(2) ("In general, a governmental unit may select its own procedure for the hearing.") But see Temp. Treas. Reg. § 5f.103-2(g)(2) ("[I]t is not necessary, for example . . . that State administrative procedural requirements for public hearings in general be observed.") But see Rev. Rul. 87-116, 1987-46 I.R.B. 7 (holding that a bond issued illegally under local law does not qualify as tax exempt under section 103).

139 I.R.C. § 147(f)(2).

140 Temp. Treas. Reg. § 5f.103-2(g)(2) ("[I]t is not necessary, for example, that the applicable elected representative who will approve the bonds be present at the hearing [or] that a report on the hearing be submitted to that official . . . .")

141 I.R.C. § 147(f)(2).


143 Temp. Treas. Reg. § 5f.103-2(h)(example 2(ii)).

144 See House TEFRA Hearings, supra, n. 12, at 1699.

145 The regulations provide decision rules for government bodies without elected officials, generally placing approval authority in the next highest governmental body with such an elected official, often the state itself. Temp. Treas. Reg. § 5f.103-2(e)(2).

146 Presumably, an official elected by a method other than at large in the entire jurisdiction (such as certain types of proportional or ward elections) would not be eligible. Temp. Treas. Reg. § 5f.103-2(e)(1)(iv). Thus in Chicago, the elected alderman who heads the City Finance Committee could not be the designate of the Mayor. Professional city managers would also be ineligible.

For projects spanning more than one jurisdiction, the PAB must be approved by an official elected at large by both jurisdictions. If there is no such official, the decision
must approve the issue. Different rules apply for host and issuer jurisdiction officials, but both officials must approve the PAB. A special rule removes local approval requirements and sends the project "upstairs" to the state government in some joint project cases.

c. Local procedural requirements imposed by the federal government fail to overcome the economic incentives to overproduce PABs

The Congress intended the public notice and hearing requirements to induce more responsibility into state production of PABs. They hoped to focus the light of public scrutiny and debate upon each PAB. Congressional action itself suggests that existing state and local procedures were not adequately rigorous in the approval process. The federal requirements are intended to supplement state and local law. At the same time, Congress hesitated to totally supplant local law and several times deferred to local standards. Nevertheless, since Congress perceived the local approval process to be deficient, Section 147 of the Code supplements local law.

The public approval requirements may be seen as a federal attempt to indirectly instill a strengthened public purpose test into the local approval process. Increased dialectical pressure upon PAB issuance will probably force the local governments to examine their costs and benefits more closely. But this process is of little value unless the local government bears some negative costs that must be balanced against the benefits of PABs. If PABs are still "cost free" to the local governments, voters, and businesses, then who will oppose them at hearings? More likely, no adverse parties will ever appear at the hearings, with the possible exception of persons who oppose the project on unrelated grounds, such as unfair competition or political philosophy. Thus, Section 147(f) completely fails to resolve the
central cause of local irresponsibility in PAB issuance: that states make the production decisions about how to spend federal PAB subsidies without any locally internalized costs. In addition, Section 147(f) inflicts a dual federal standard on the bond issuer which often displaces familiar local approval requirements with vague federal standards.

2. Federal Interference With Intra-State Allocation Of PAB Volume Caps

In a second group of federal procedural restrictions, Congress devised an interim allocation scheme which grants half of each state's PAB cap to the central state government and its agencies.\textsuperscript{155} The other half is allocated to local governmental units which are authorized under state law to issue PABs.\textsuperscript{156} These local allocations are based upon each local jurisdiction's population.\textsuperscript{157} Special rules cover overlapping jurisdictions.\textsuperscript{158} Governors may alter this allocation scheme by proclamation, pending action by the next session of the state legislature.\textsuperscript{159} In Illinois, however, the allocation to constitutional home rule units\textsuperscript{160} may not be altered by the state government without the permission of the unit.\textsuperscript{161} This provision effectively protects Chicago's allocation from the political control of the State of Illinois. Nationwide, the political impact of this interim allocation scheme upon state and local government relations may be great.\textsuperscript{162} State legislatures will control the allocation of billions of dollars in federal subsidy for private businesses. The interim allocation divests half of this power from the state and gives it to multitudes of local governmental units, such as cities, counties, and local Industrial Development Authorities. Cities and counties will demand at least their interim allocative share and will balk at giving up more of challenging the validity of a voter referendum as unfairly hiding the fact that it authorized a PAB for a certain shipyard facility).

\textsuperscript{155} I.R.C. § 146(b).
\textsuperscript{156} I.R.C. § 146(c)(1).
\textsuperscript{157} Id. In general, a state's allocation is split into two quotas: 50% goes to the central state government and its agencies, the other 50% is split between all local governments based upon their population.
\textsuperscript{158} I.R.C. § 146(c)(2).
\textsuperscript{159} I.R.C. § 146(e).
\textsuperscript{160} These provisions apply only to units within the State of Illinois. I.R.C. § 146(d)(3)(C); see General Explanlation (1986), supra, n. 111, at 1199.
\textsuperscript{161} I.R.C. § 146(e)(3). Such units will receive 100% of their per capita share of the state allocation, twice what units receive under the interim allocation for all other states. See I.R.C. § 146(d)(3).
\textsuperscript{162} The interim allocation operates as a defacto standard. The volume cap itself forces a political struggle within a state and between local governmental jurisdictions over allocation of the available federal tax subsidies.
this federal subsidy to others. More and more cities can be expected to seek federal protection of their allocation under Title 26 like Chicago did.\footnote{The special Illinois provision treated Chicago and other cities as States for federal allocation purposes. This profoundly interferes with state and local government relations as the city and the federal government bypass the state altogether. See supra, n. 160 and accompanying text.}

Effective volume caps will encourage state governments to allocate their available PABs to the most efficient users. Within each state, agencies, cities, counties, and Industrial Development Authorities will compete for the valuable PABs that are available. A market for PABs will develop within each state. The interim allocation plan interferes with this market by vesting an "entitlement" with each local jurisdiction based upon population rather than need. Each local jurisdiction will argue against any reduction in its allocation below the federal interim standard. More cities like Chicago may receive a federal allocation. Whenever local jurisdictions are successful in obtaining allocations based solely upon population, the subsidy will probably be misallocated.

3. Miscellaneous Federal Restrictions

Congress has added several other federal procedural requirements to certain tax-exempt bonds. For example, each bond issuing authority must provide quarterly information returns to the Internal Revenue Service describing the type and quantity of all tax exempt bonds issued.\footnote{I.R.C. § 149(e) (1986); Temp. Treas. Reg. § 1.149(e)-1T, 1987-20 IRB 4, T.D. 8129.} This provision is responsible for much of the empirical data used in this Article. Additionally, each bond must now be issued in registered form.\footnote{A registered bond, unlike a bearer bond, is owned by the registered owner, rather than the bearer of the instrument. The registration requirement applies to all section 103 bonds, not just PABs. I.R.C. § 149(a) (1986).} South Carolina unsuccessfully challenged the registration provision in a case recently decided by the Supreme Court.\footnote{South Carolina v. Baker, supra n. 96, (No. 94 Orig.).}

V. Conclusion

The economic incentives inherent in the PAB market were not carefully crafted federal policy, but rather evolved haphazardly. States were allowed to produce beneficial PABs with all direct costs carried by the federal government. In a similar fashion, the federal response failed to construct a coherent set of restrictions which altered the underlying economic incentives. The present regulations are exceedingly difficult and fraught with
hazards for the unwary. In some respects, this Article is a case study of the failure to set regulatory objectives and policy before embarking upon a program of regulation. Any workable solution must address the central problem of state and local incentives to overproduce PABs.

Among the alternatives currently in the Code or recently contemplated by Congress, the mandatory participation requirement places the greatest incentive upon issuers to efficiently produce. All of the other restrictions could be replaced by a simple participation requirement. The tangle of federal public purpose requirements, volume caps and procedural restrictions could be cleared away. Several sections of the Code could be deleted entirely. Surely this is tax simplification instead of strangulation.