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Domestic Policy Subcommittee
Oversight and Government Reform Committee
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Thank you Mr. Chairman and Committee members for the privilege of testifying before you. I am here to comment on the implications of the federal tax exemption on municipal bond interest for federalism and democratic governance, and the relationship between those implications and the financing of sports stadiums through payments in lieu of taxes or PILOTs. I am a professor at New York University School of Law. One of my areas of specialization is local government law, with some emphasis on local government finance. I am not, however, and do not purport to be a tax lawyer. In addition to my comments here, I have submitted written testimony for the record.

I. The Scope of the Federal Tax Exemption

My remarks today are directed at defining the proper scope of the federal tax exemption on interest for debt obligations of states and their political subdivisions, commonly called municipal bonds. Any analysis of that issue must begin with the proposition that the exemption constitutes a subsidy from the federal government to the entity that benefits from the proceeds of the debt. This subsidy is the consequence of the fact that issuers are able to sell their debt at lower interest rates than would otherwise be the case because the federal government is willing to forgo the income that it would receive by collecting tax on the interest that purchasers of the debt receive as ordinary income.

Moreover, there is a substantial argument that the tax exemption constitutes an inefficient subsidy in that it costs the federal government more in forgone income than it returns to the states and their political subdivisions in the form of reduced borrowing costs. To see how that is the case, consider that, according to Federal Reserve statistics, at the end of 2007, the yield on a mixed-grade tax-exempt bonds was approximately 4.42 percent at a time when the yield on AAA industrial bonds was 5.49 percent. This means that an investor who was in the 35% marginal tax bracket and who purchased a $10,000 municipal bond would receive $442 annually in interest income on that bond. As a result of the federal tax exemption, none of that income would be taxed and the investor would be left at the end of each year with all $442 in interest income. If the best alternative investment for the same investor would have been a taxable AAA corporate bond, he or she would receive $549 annually in interest income. But at a 35% tax rate, that investor would have paid approximately $192 annually in federal income tax on that investment. The federal government, by virtue of the tax exemption on the municipal bond, has agreed to forgo this $192, minus the costs of collection. But note that the locality that issued the tax-exempt bond has only saved $107 – the difference between the $442 it had to pay in interest and the $549 it would have had to pay if interest on its bond had been taxable. The potential inefficiency, therefore, arises from the fact that, in order to confer a $107 subsidy on the issuer, the federal government has had to forgo income of $192, less the costs of collection. The amount of the inefficiency will depend on the yield ratio between tax-exempt and taxable bonds (or other alternative investment), which in my example from the end of 2007 was about .80, and on the effective tax rate of the investor. But for virtually any investor for whom purchase of a municipal bond rather than a corporate bond of equal quality would be financially beneficial, some inefficiency is likely to remain. This inefficiency may not be sufficient to eliminate the tax subsidy – any replacement for it could be equally inefficient. But the potential inefficiency does provide a reason to ensure that the scope of the exemption is properly defined to satisfy some purpose sufficient to justify the exemption.

It is important to note the nature of the subsidy inherent in the tax exemption, because it implicates the question of who is paying for, and making financing decisions for projects that purportedly serve locally determined public purposes. But it is also important to understand what is not implicated by the availability or unavailability of the tax exemption to subsidize particular projects. The claim is sometimes made that denial of the tax exemption interferes with local decisions about which capital projects to pursue or the transactional structure with which to pursue them. I believe that stating the issue in terms of interference or second guessing of local decisions mischaracterizes the effects of federal decision making. Even in the absence of an exemption, states and localities are perfectly free to pursue any project that they deem appropriate, consistent with state constitutional and statutory requirements concerning such issues as public purpose and financing structures. The unavailability of the federal tax exemption only obligates the locality to pay the full market cost of its decisions, rather than to have part of those costs borne by nonresident taxpayers. But if those nonresidents receive no benefit from the project, then it is unclear why the federal tax dollars that they pay should help to subsidize it. Indeed, from an economic perspective, we would want the locality to bear the full costs of the project, so that local officials have an incentive to balance the purported benefits of the project against its costs and to induce local residents to ensure that their tax dollars are being spent in a manner consistent with their preferences.

The inquiry into whether a project is desirable from a local perspective, in short, is independent of the inquiry into who should pay for it. We sometimes hear, for instance, the phrase "public purpose" injected into debates about the use of tax-exempt financing. It is important to understand that the phrase can mean very different things depending on whether it is used to refer to the propriety of a locality undertaking a project at all or to the propriety of federal participation in financing the project. A project that returns benefits that are wholly concentrated within the issuer's jurisdiction may well satisfy state constitutional "public purpose" requirements. But that fact alone does not entail that the same project constitutes a project that satisfies a "public purpose" as that phrase is often used to describe the proper scope of the federal tax exemption. Where the project confers no spillover benefits to other localities, even a project that satisfies a locally determined public purpose does not necessarily satisfy a federal one. The same is true for financing structures. Funding mechanisms such as PILOTs may very well serve the interests of particular local governments, and state governments may have appropriate reasons to allow their use. But that is a very different issue from whether the federal government must make its subsidy available regardless of state allowances. No principle of our federalism suggests or requires that the federal government must subsidize every project or transactional structure that localities seek to implement.

What, then, defines the conditions that justify availability of this federal subsidy? One way to think about this question is by analogizing the subsidy to its economic functional equivalent: a block grant made by the federal government that allows the recipient to use funds generated at the federal level for local purposes. This identity between grants and exemptions allows us to focus on those conditions in which the former is appropriately made by the federal government to states and localities and thus provides some insight into the proper scope of the tax exemption.

There are two circumstances under which such a subsidy is appropriate. The first involves projects undertaken by states and localities that have positive external effects, that is, projects that return benefits beyond the jurisdiction that utilizes the funds. Assume, for instance, that a locality is considering construction of a project that could reduce pollution in multiple jurisdictions. Left to its own devices, that locality would presumably compare the local costs that it would incur by pursuing the project against the local benefits that it would enjoy. But it is plausible that by incurring additional costs, the project would create a higher level of pollution control that would reduce pollution in neighboring jurisdictions as well as in the jurisdiction undertaking the project. The locality, however, has no incentive to confer benefits on those jurisdictions. Indeed, it has an incentive not to do so because enlarging the project would increase local costs, but would not increase local benefits. It would confer those benefits only on other jurisdictions that paid nothing towards the project. Thus, we would expect that the locality would only engage in the lower level of pollution control even though, from a social perspective, the higher level of pollution control was warranted.

If we wanted to induce the locality to engage in the higher level of pollution control, we could do so through a subsidy – for instance through a grant in an amount that equals the difference between the less expensive project and the more expensive project that generated the benefits that spill over into the neighboring jurisdictions. Tax dollars collected at the federal level from those neighboring localities that benefit from the larger project would thus be used to fund it. The locality would presumably be willing to engage in the higher level of pollution control because it was not paying the marginal costs of conferring benefits on neighboring jurisdictions. Another way to accomplish an equivalent subsidy, however, would be to provide a tax exemption on the interest that the locality would have to pay on funds necessary to obtain the capital to construct the pollution control project. That tax exemption would have the same effect as the grant insofar as it reduced the borrowing costs of the locality and made it indifferent between the more parochial project and the expensive one that conferred benefits on neighboring jurisdictions. The amount of the subsidy that the federal government would be providing might be only the roughest of approximations of the cost of providing external benefits, but such rough estimates may ultimately be less expensive to provide than funding a federal bureaucracy to determine the precise costs of creating benefit spillovers for all locally funded projects that have such effects.

The second category of projects that warrant federal subsidy is a bit more nebulous, and arguably broader than those projects that generate benefit spillovers. Basically, this category encompasses projects that enhance the local autonomy of local governments generally. The benefits of autonomous local government are substantial. Given the latitude to experiment, entrepreneurial states and political subdivisions can generate projects and programs that, if successful, can be copied elsewhere, and that, if unsuccessful, limit the costs of failure. It was, perhaps, in this sense that Justice Brandeis famously referred to states as "laboratories."

Autonomous governments also allow individuals to pursue their own view of the best mix of publicly provided goods and services. Localities provide numerous public goods to their residents: roads, schools, open space, police protection, proximity to workplace, etc. But no local government can provide all public goods, and the provision of one set of public goods may preclude provision of another. Different localities will offer different baskets of public goods and services at particular tax prices, and mobile individuals will gravitate to those localities that offer the basket of goods and services most consistent with their own residential preferences. While this is a complicated subject, I think that most lawyers and economists who have studied the matter would agree that local sorting enhances the efficient delivery of local public goods by matching taxpayers with the goods and services they desire.

Autonomous local governments also confer broader social benefits by acting in a manner that attracts a tax base that they believe will help enrich the community. This interlocal competition, in theory, at least induces firms to locate where they will be most productive and induces localities to improve their educational and social services that productive firms would find attractive. In order to encourage local entrepreneurial behavior, the federal government has an interest in projects that may generate benefits that are wholly internal to the locality, but that, if successful, would benefit other localities as well. The federal government, in effect, may serve as a venture capitalist with respect to certain projects.

If local autonomy produces these broad social benefits, then it is appropriate for the federal government to subsidize local activity that advances the capacity of localities to pursue autonomous conceptions of entrepreneurial, competitive, and governmental activities, as long as those activities do not run afoul of broader social objectives. The broad social benefits that can be realized through local autonomy are possible only if localities have the capacity to provide the basic services that we think are best administered at a decentralized level: basic government, education, social services, and a judicial system. Thus, federal subsidies are appropriate to ensure that localities possess the basic infrastructure and capital capacity that is a prerequisite to more productive local government. A federal subsidy that provides broad discretion to localities to implement projects that they deem useful is likely to serve that objective better than targeted grants that implement a more centralized view of what localities ought to do. A tax exemption that attaches to debt that is conducive to local autonomy has the potential to play the desired role. I will argue momentarily, however, that if the objective is to enhance local autonomy, it is crucial that the federal subsidy be used in a manner that actually reflects local preferences.

II. Is Current Law Consistent with the Theory?

Current federal tax law maps onto this template closely, though imperfectly. First, it provides a relatively broad exemption for interest on bonds issued to fund projects that will have multijurisdictional effects, even where those projects might not otherwise qualify for the exemption because they constitute private activity bonds. Qualified private activity bonds that are eligible for the tax exemption tend to consist of categories of activities, such as airports, docks, wharves, inter-urban rail facilities, solid waste disposal facilities, and public educational facilities, that have substantial effects beyond the jurisdiction of the nominal issuer. Thus, it is plausible to conclude that these projects would not have been undertaken, or would not have been undertaken to the same extent, without the federal subsidy.

In addition, federal tax law permits the tax exemption to be used to foster local conceptions of the ideal mix of public goods. For instance, if a locality truly believes that a sports stadium will provide it with a competitive advantage or enhance residents' sense of community, it may use the federal tax exemption to pursue that vision. But, and this is an important condition, federal tax law contains a variety of provisions that can properly be understood as imposing on a locality the obligation to ensure that the decision to undertake a project does, in fact, reflect the preferences of local residents. If it does not, if the project is undertaken solely to satisfy the interests of a relatively small group of constituents, then the project cannot readily be linked to fostering local autonomy. As a result, the federal interest in subsidizing the project is diluted. The availability of the tax exemption under those conditions looks more like an effort by which local officials can simply confer a significant benefit on favored interests in the form of lower financing costs, and shift the lion's share of the subsidy to federal rather than to state and local taxpayers. From the perspective of local officials, this is a winning strategy. They can confer an advantage onto local interest groups, but externalize the related costs in a manner that saves them from having to increase taxes or charges on their constituents.

The result is that many of the conditions for the issuance of municipal bonds are linked to transparency and democratic accountability in the local decision-making process. Satisfaction of these conditions enhances the likelihood that local residents will monitor their political officials to ensure that the projects that are subsidized in the name of fostering local autonomy and generating significant spillovers will, indeed, have those effects. The need for these conditions is apparent from the literature on tax expenditures, i.e., losses to the public treasury that materialize as a result of deductions or credits, rather than from direct expenditures from funds that are paid into the treasury. Tax expenditures are more difficult to monitor because they fall outside the normal process of public appropriation and expenditure. Whereas a direct expenditure from the municipal budget, such as the local parks department budget, can be monitored with relative ease by looking at a particular line in the overall municipal budget, it is far more difficult to monitor tax expenditures, because they entail forgone income that, because it is never received, does not show up in the municipal budget.

This meshing of tax policy and support for transparency and democratic accountability is implicit in the requirements that issuers of bonds must satisfy in order to qualify for the federal tax exemption. To continue my example of the locally desired stadium, the locality may take advantage of the federal subsidy if it is willing to finance a stadium from municipal revenues that have been generated by the traditional taxing mechanism used by the city to fund the public goods and services that it provides – what are referred to in Treasury Department regulations as "generally applicable taxes." Although, or maybe because, we tend to complain about the taxes that we must pay, generally applicable taxation has a constraining effect on government and a beneficial effect on democratic governance. In order to ensure optimal taxation rates, constituents tend to monitor expenditures made by their officials with tax dollars. I am not suggesting that every taxpayer monitors the municipal budget. But there is a tendency for some groups or individuals with an intense interest in the expenditure process to ensure that tax dollars are not being spent in a manner inconsistent with the interests of constituents generally. When generally applicable taxes are paid into a single revenue pool, such as a municipal treasury, and then appropriated through a process in which different claimants compete before a legislative body for a share of that pool, the outcome is more likely to reflect expenditures that constituents prefer.

Thus, the underlying assumption of extending the federal subsidy to bonds paid from generally applicable taxes is that if the project, even one like a stadium that does not fulfill a traditional governmental function, must compete for part of the municipal budget, and if those who pay the taxes and fees that are used for debt service support the project, as evidenced by their willingness to have their exactions dedicated to it as opposed to alternative projects or lower taxes, then there is a significant likelihood that the project is consistent with the ideal mix of goods and services that define local autonomy. The fact that governmental bonds are paid for from revenues that are appropriated through the normal budgetary process means that the decision to pursue and finance the project is relatively transparent and easily monitored by local constituents who have an incentive to monitor government expenditures. Of course, the issuer of the debt must still satisfy state constitutional and statutory requirements for localities. As a result, particular projects that confer significant benefits on private parties, such as a sports stadium, may run afoul of state constitutional limitations on the purpose of governmental borrowing. But those state constitutional limitations should be disaggregated from any inquiry into the proper scope of the tax exemption. The key point is that, by inducing states and localities to determine in a transparent manner which projects to undertake with revenue generated by their own generally applicable taxes, federal tax law significantly supports the kind of local autonomy that underlies our federalism.

Once we move away from state and local obligations that are supported by generally applicable taxes, it is notable that even qualified private activity bonds that are eligible for the tax exemption include requirements that enhance transparency and democratic accountability in the local decision making process. These requirements enhance the likelihood that both the project to be financed and the means of financing reflect constituent preferences. For instance, most forms of private activity bonds, even those that confer sufficient public benefits to warrant eligibility for the tax exemption, are subject to a volume cap imposed on jurisdictions.[1] This

[1] See 26 U.S.C. § 146.

requirement plays a role similar to the role in the case of governmental bonds of having a single pool of general revenue over which sponsors of any particular project must compete. If private activity bonds are secured by private payments that do not flow into the general treasury, then they will not be subject to the same competitive process with its attendant transparency and susceptibility to monitoring. The volume cap substitutes for the benefits of the budgetary process by creating competition for projects that are eligible for tax-exempt financing. That competition means that sponsors of potential projects will have to persuade local officials that their projects return more benefits than alternatives. Sponsors of competing projects have incentives to aggregate support for their proposals among local constituents. In short, the volume cap requirement increases the likelihood of debate about which proposed projects are most beneficial, a process that is consistent with ensuring that decisions reflect the interests of the community at large.

Finally, a private activity bond is not a qualified bond eligible for the federal exemption unless the bond satisfies a "public approval" requirement.[2] That requirement can be satisfied only if the governmental unit that issues the bond or on behalf of which the bond is issued approves the issue through its elected representatives after "a public hearing following reasonable public notice," or through a voter referendum. Note that what must be approved is the issue of the bond, not simply the underlying project. These conditions demonstrate that the objective of the public approval requirement is to facilitate public monitoring of the local decision making process concerning the financing of the project, and to ensure that projects that benefit from the federal tax exemption reflect local preferences, and is not simply a project that serves the interests of a relatively small group of residents who have disproportionate access to the local decision making process. What is also notable is that these requirements apply even where the bond is not payable from the general revenues of the issuer and the locality's credit is not pledged to pay debt service.

III. The Role of PILOTs

How do payments in lieu of taxes, or PILOTs, fit into this scheme? The answer to that question affects the difficult inquiry into the conditions under which PILOTs should qualify as "generally applicable taxes" rather than private payments, so that projects financed with PILOTs

[2] See 26 U.S.C. § 147(f).

would escape the strictures of private activity bonds. The issue is difficult because PILOTs are a bit of a hybrid, with characteristics of both traditional taxes and traditional private payments. Treasury Department regulations describe a generally applicable tax as . . . . "as an enforced contribution exacted pursuant to legislative authority in the exercise of the taxing power that is imposed and collected for the purpose of raising revenue to be used for governmental purposes." PILOTs arguably satisfy the definition insofar as they are substitutes for and are based on property taxes that constitute an enforced contribution. The 2006 proposed amendments to the regulations would clarify this view by requiring eligible PILOTs to be variable with the assessed value of the property in respect of which they are paid.

But to the extent that specific PILOT payments are dedicated to debt service for a particular project, those payments arguably have more in common with the kind of special charge, such as an assessment related to a particular municipal improvement, that the regulations exclude from "generally applicable taxes" that must be used for general governmental purposes. The proposed amendments suggest something similar by excluding PILOTs that are based in any way on debt service for an issue. Even PILOTs that are not explicitly predicated on debt service, but the proceeds of which are dedicated to debt service of a particular improvement may have the characteristic of being "a payment for a special privilege granted or service rendered" that is not a generally applicable tax.[3]

In resolving this ambiguity about the proper characterization of PILOTs for purposes of the federal tax exemption, it is useful to consider the effects of those payments and to determine how those effects fit with the issues of transparency and democratic accountability that I have argued pervade generally applicable taxes and other features of the exemption. From this perspective, PILOTs appear to bear greater resemblance to the exactions that fall within the scope of private payments than taxes.

As a purely economic matter PILOTs may be equivalent to other forms of subsidies for financing infrastructure or attracting tax base to a locality. A firm that is considering locating in a jurisdiction may be indifferent as between an arrangement that grants it a property tax abatement of 80 percent and an arrangement that requires it to make payments in lieu of taxes for the use of land owned by the locality where those payments amount to 20 percent of the property

[3] 26 C.F.R. § 1.141.4(e)(3).

taxes that would otherwise be payable. But from the perspective of the role of tax payments in inducing transparency and democratic accountability, these structures may differ dramatically. The reason for this lies in the way that PILOTs are treated in the budgetary process. Assistant Secretary Treasury Solomon has correctly noted on multiple occasions that the federal tax exemption on bonds itself is less susceptible to monitoring because, unlike direct appropriations, its use is not tracked through the appropriations process.[4] Instead, as I suggested above, tax expenditures like the exemption suffer from a lack of transparency because they do not show up on governmental budget lines. While the unabated portion of property taxes still flow into the public treasury, PILOTs may lack the same transparency and the susceptibility to monitoring. That is the case, at least, to the extent that they are treated in municipal budgets differently than taxes, are dedicated to particular payments rather than paid into the local treasury to be appropriated in the same manner as other expenditures, or are treated as contract revenues to be transferred or disposed of through a process that varies from and is less observable than appropriations from a fixed budget. For instance, the Mayor of New York City has taken the position that PILOTs constitute contractual rights that had been negotiated by the city rather than tax payments. As such, the Mayor's Office claimed that PILOTs were not revenues of the City susceptible to payment into the general fund and control by the City Council; instead, they were assignable to City projects within the discretion of the Mayor. Similarly, the Ohio Supreme Court has declared that PILOTs are not taxes subject to voting requirements where the PILOT payments were made to an earmarked fund.[5]

Indeed, the difficulties related to monitoring the use of PILOTs are exacerbated to the extent that PILOTs are deemed generally applicable taxes, so that the bonds they secure qualify as governmental bonds rather than private activity bonds. Under those circumstances, failure to treat PILOTs in the same manner as tax revenues paid into and appropriated from the municipal treasury through the normal budgetary process means that the bonds that they secure will not be scrutinized through the monitoring process that typically applies to tax and exaction revenues.

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[4] See Testimony of Treasury Assistant Secretary for Tax Policy Eric Solomon before the House Oversight Subcommittee on Domestic Policy on Tax Exempt Financing, October 10, 2007; Statement of Eric Solomon, Acting Deputy Assistant Secretary of Tax Policy, Hearing on the Use of Tax-Preferred Bond Financing before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, U.S. House of Representatives, March 16, 2006 at 11.

[5] City of Dayton v. Cloud, 285 N.E.2d 42 (Ohio 1972).

On the other hand, because the bonds secured by PILOTs do not qualify as private activity bonds, they are not subject to the alternative means of assuring transparency and monitoring, such as volume cap and the public approval requirement. In short, at least to the extent that PILOTs are treated differently from taxes, these payments permit evasion of the kinds of democratic scrutiny that ensure projects and financing structures that qualify for the federal tax exemption reflect constitute preferences and serve the objectives of local autonomy.

None of this is to say that the use of PILOTs to finance local projects is illegitimate. If a state or locality believes that PILOTs return benefits in attracting tax base over and above the benefits that could be obtained from other forms of subsidies, such as property tax abatements, direct grants, or exemptions, that jurisdiction should be perfectly able to employ that structure. But nothing about the fact that PILOTs are useful from a local perspective requires that the federal government similarly embrace the concept or allow use of a federal subsidy to support it, notwithstanding that its use is inconsistent with federal interests. On the other hand, if a particular state or locality, such as my own, is disadvantaged relative to other states by virtue of state constitutional clauses that preclude the use of financing structures more amenable to federal subsidy, then the state or locality is perfectly free to alter those limitations in order to avail itself of the same benefits obtainable by others.   Indeed, it is plausible that by disadvantaging opacity in public finance, federal tax law can provide useful incentives for the reform of anachronistic mechanisms of state and local finance.

My thanks for your time and attention. I would be pleased to answer any questions you might have.