THE FEDS ARE ALREADY HERE: THE FEDERAL ROLE IN MUNICIPAL DEBT FINANCE

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Abstract

Should the federal government be involved in the regulation of municipal debt finance? The answer is arguably not. But this theoretical dispute is not the focus of this Article because, in fact, the federal government already regulates municipal debt finance extensively, generally much more extensively than the states regulate their municipalities' use of debt. The primary source of federal regulation is the securities laws. Less well-known is that federal tax law also serves as an important constraint. This Article surveys and critically evaluates these federal laws, and comes to three tentative conclusions. First, the current federal oversight "system," unplanned and ad hoc as it is, has been effective. Second, in part because the current system has never been thought of as a comprehensive system, there are low-hanging fruit in terms of making the system work better. To the extent the federal government does not put these reforms in place, states should. Third, even an optimally operating federal overlay does not absolve the states from more careful regulation of the financial affairs of their localities, particularly as to the use of debt. Above all, what the federal government does not—and ought not—do is provide localities with the expertise to use debt optimally; this is another area where the states should focus their reform efforts.

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I. Introduction

What role should the federal government play in local government finance? Defensible answers run the gamut.[1] Extensive involvement is arguably an unjustified intrusion into the ability of local communities to choose for themselves.[2] And local choice would be desirable not only because of the good of self-determination, but also because it is better for the federal system as a whole if localities can compete against each other and face the consequences without the federal government imposing a unitary taxing and spending solution.[3] On the other side, it could be coherently objected that any advantages provided by the multiplicity of local governments are not worth it. Local governments are (generally) too small to have much control over their economic destinies.[4] Furthermore, they are often too small to be able to hire sophisticated financial professionals to manage their affairs. Metropolitan areas are the drivers of economic growth in this country,[5] and the central government therefore has a compelling interest in protecting localities from forces they cannot control and from financial transactions they do not understand.[6]

This is just a thumbnail sketch of this debate, though there is not much written on the federal-local divide per se. Much more ink has been spilled over the proper allocation of powers between states

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[1] I have recently surveyed this debate as to the state role. *See generally* Darien Shanske, *Local Fiscal Autonomy Requires Constraints: The Case for Fiscal Menus*, 25 STAN. L. & POL'Y REV. (forthcoming June 2014), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2340218.

[2] *Cf.* Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 281, 298–99 (2012).

[3] *See, e.g.*, Clayton P. Gillette, *Fiscal Federalism as a Constraint on States*, 35 HARV. J.L. & PUB. POL'Y 101, 101–04 (2012).

[4] Richard C. Schragger, *Rethinking the Theory and Practice of Local Economic Development*, 77 U. CHI. L. REV. 311, 313 (2010).

[5] ALAN BERUBE, BROOKINGS METRO. POLICY PROGRAM, METRONATION: HOW U.S. METROPOLITAN AREAS FUEL AMERICAN PROSPERITY 22 (Brookings Institution 2007), *available at* http://brookings.edu/~/media/research/files/reports/2007/11/06%20metronation%20berube/metronationbp.pdf.

[6] On the federal role in general, see Darien Shanske, *How Less Can Be More: Using the Federal Income Tax to Stabilize State and Local Finance*, 31 VA. TAX REV. 413, 426–29 (2012).

and localities.[7] This makes sense both as a matter of law and history. The federal government does not—and generally cannot—regulate the fiscal affairs of localities directly.[8] I have argued elsewhere in favor of a state-level regulator to help localities use debt more wisely.[9] It would seem a waste of time to argue for the creation of a federal-level agency responsible for ensuring that localities use debt properly.

Yet it turns out that there are at least two such federal agencies already. You may have heard of them. They are called the Securities and Exchange Commission ("SEC") and the Internal Revenue Service ("IRS"). Recent decisions of federal bankruptcy courts, particularly in connection with Detroit, suggest that federal bankruptcy law is about to become much more important to municipal finance;[10] the federal courts are not a federal agency per se, but it seems likely[11] that the development of the federal common law of municipal bankruptcy will soon be playing nearly as

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[7] *See supra* note 1 and accompanying text.

[8] *See, e.g.*, Ashton v. Cameron Cnty. Water Improvement Dist. No. 1, 298 U.S. 513, 531–32 (1936) (striking down first federal law providing for municipal bankruptcy because it interfered with the states' sovereign control over the fiscal affairs of their localities by permitting voluntary bankruptcy submissions without state consent).

[9] *See* Shanske, *supra* note 1, at 13.

[10] *See, e.g.*, *In re* City of Detroit, Mich., No. 13-53846, 2013 WL 6331931, at *60–61, *80–81, *83 (Bankr. E.D. Mich. Dec. 5, 2013); City of San Bernardino, Cal., 499 B.R. 776, 778–93 (Bankr. C.D. Cal. Oct. 16, 2013).

[11] At least for a while. States must authorize municipalities to file for bankruptcy and many do not. *See* 11 U.S.C. § 109(c)(2) (2012). Only thirteen states allow a filing with no further state action. James Spiotto, Chapman & Cutler LLP, Remarks at the Field Hearing on the State of the Municipal Securities Market Distressed Communities 39 (July 29, 2011), *available at* http://sec.gov/spotlight/municipalsecurities/statements072911/spiotto.pdf. If federal bankruptcy protection becomes more powerful, more states might be expected to act as gatekeepers. California AB 506, a new gatekeeper provision passed in the aftermath of the Vallejo bankruptcy, is arguably an example of such a counter-trend. *See* CAL. GOV'T CODE §§ 53760–53760.7 (West 2012) (detailing that "[a] local public entity in this state may file a petition and exercise powers pursuant to applicable federal bankruptcy law if either of" two conditions occur or have occurred). Thus, paradoxically, if municipalities were to win a substantive right to trim vested pensions in federal bankruptcy court as a matter of federal law, they might find themselves less able to access this remedy as a matter of state law.

important a role in shaping local fiscal power as the state constitutional law that grants localities fiscal powers to begin with. It is too late to have the debate about whether the federal government should have an extensive role in local finance; the relevant—and pressing—question is what that role should be.

This paper cannot even sketch all the ways in which federal law and federal entities shape local fiscal power, much less evaluate them normatively. The goal here is more modest. I will focus only on sketching what I take to be the unsurprising role of the SEC and the surprising role of the IRS. These entities have long been involved in the issuance of local debt. Discussions of local government finance have not focused on this federal role. Yet understanding their role reveals two paradoxes. Within the local government literature, there are arguments in favor of more local control of debt issuance versus arguments for more state control.[12] Those who argue for more local control do not necessarily believe that local voters themselves are up to the task of carefully monitoring the local use of debt. Rather, such commentators typically have more trust in the market than the state.[13] Bondholders do have incentive to monitor local debt, though how much is another question.[14] Yet bondholders are primarily reliant on the *federal* disclosure regime.[15] Thus, paradoxically, the argument against more state oversight decomposes into an argument for the current system of federal rules providing the primary

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[12] *See* Clayton P. Gillette, *Fiscal Home Rule*, 86 DENV. U. L. REV. 1241, 1255 (2009).

[13] *See id.* ("[R]eliance on market mechanisms that signal both officials and residents of the propriety of different fiscal tools may be more responsive to local conditions than . . . state control that is responsive to its own set of interests that may interfere with the local market.").

[14] At least through intermediaries, such as underwriters. *See generally* Clayton P. Gillette, *Bondholders and Financially Stressed Municipalities*, 39 FORDHAM URB. L.J. 639 (2012) ("[W]hile bondholders suffer from significant disincentives and collective action problems that discourage monitoring, some financial intermediaries that act on behalf of bondholders already invest in monitoring local fiscal prudence in a manner that aligns with the interests of residents."). I should note that, though Professor Gillette is clearly a relative fan of bondholders, I am certain that, as a leading expert on municipal finance, he is aware of the shortcomings in the federal system discussed below. I have not, however, seen him address how states should respond to these federal lacunae.

[15] *See* ROBERT S. AMDURSKY & CLAYTON P. GILLETTE, MUNICIPAL DEBT FINANCE LAW: THEORY AND PRACTICE § 6.4, at 348–50 (1992).

framework. Indeed, to the extent that most commentators correctly find the current municipal disclosure regime to be deficient, then advocates of market versus state oversight ought to endorse more federal oversight of municipal finance.

The role of the IRS leads to a slightly different paradox. State constitutions, unlike the federal constitution, contain a wealth of detail about fiscal matters. For instance, state constitutions typically prohibit the gifts of public funds[16] and demand that public funds only be spent on a public purpose.[17] If enforced strictly, these provisions could have important implications on the ability of states (and localities) to finance many of the programs we now take for granted—for instance, a public assistance program for the poor is arguably a gift of public funds.[18] Yet these provisions have not been strictly enforced at least in part because the boundaries they seek to patrol are so nebulous. These fiscal provisions of state constitutions are what Richard Briffault has aptly called the "disfavored constitution."[19]

What does this history have to do with the IRS? The federal government grants states and localities a tax exemption on the interest they pay on their bonds.[20] In various ways, the federal government came to believe that the states were abusing this privilege.[21] Because it is a tax privilege, ensuring that it is used properly fell to the IRS. This has meant that the IRS has had to consider, among other things, whether various local expenditures are sufficiently "public."[22]

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[16] *See* CAL. CONST. art. XVI, § 6 ("The Legislature shall have no power . . . to make any gift . . . of any public money or thing of value to any individual, municipal or other corporation . . . .").

[17] *See id.* § 3 ("No money shall ever be appropriated or drawn from the State Treasury for the purpose or benefit of any corporation, association, asylum, hospital, or any other institution not under the exclusive management and control of the State as a state institution . . . .").

[18] *See id.* § 11 (specifically authorizing relief programs).

[19] Richard Briffault, *Foreword: The Disfavored Constitution: State Fiscal Limits and State Constitutional Law*, 34 RUTGERS L.J. 907, 909–10 (2003).

[20] *See* I.R.C. § 103 (2012) ("[G]ross income does not include interest on any State or local bond.").

[21] *See infra* notes 53–56 and accompanying text (discussing two ways in which states abused the privilege of issuing tax exempt securities).

[22] IRS Tech. Adv. Mem. 127670-12, at 12 (Aug. 23, 2013) [hereinafter TAM 127670-12] (discussing whether an issuer was sufficiently "governmental").

What should we think of *federal* tax bureaucrats enforcing the *dis*favored *state* constitution? On the one hand, this seems clearly to be a daft situation, as seemingly demonstrated by a recent IRS incursion into the details of municipal finance that I will discuss *infra*. Yet I am not certain that this is the correct analysis. First, there are solid, if not rock-solid, arguments for the current role of the IRS.[23] Second, the relatively successful role of the IRS in enforcing the disfavored constitution[24] indicates how states could and should undertake this role for themselves—through an expert agency enforcing changeable statutes and regulations, and in dialogue with the professional community.

II. The Federal Securities Laws

In this section, I will outline the role of the federal securities law very briefly, as many extensive summaries are readily available.[25] The key point is that municipal securities are subject to the federal securities law, though in a circuitous manner. The key components of federal securities regulation are the Securities Act of 1933 ("Securities Act")[26] and the Securities Exchange Act of 1934 ("Exchange Act").[27] Most municipal securities are largely exempt from both Acts.[28] Thus, municipalities do not need to issue securities in the form prescribed by the Securities Act[29] nor provide regular disclosure in the form provided by the Exchange Act.[30]

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[23] See discussion *infra* Part III.

[24] *See infra* notes 73–77 and accompanying text.

[25] *See, e.g.*, SEC, REPORT ON THE MUNICIPAL SECURITIES MARKET 27–31 (2012), *available at* http://sec.gov/news/studies/2012/munireport073112.pdf.

[26] Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (2012).

[27] Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78pp (2012).

[28] *See infra* notes 29–30 and accompanying text (citing municipal securities exemptions).

[29] *See, e.g.*, Securities Act of 1933 § 3(a)(2) (exempting from the Securities Act any security issued "by any political subdivision of a State").

[30] *See, e.g.*, Securities Exchange Act of 1934 § 15B(d)(2) ("The Board is not authorized . . . to require any issuer of municipal securities . . . to furnish . . . any application, report, document, or information with respect to such issuer . . . .").

Yet municipal securities are not exempt from the antifraud provisions of either Act,[31] and this is the hook by which the SEC, through rulemaking, has required that municipal issuers provide initial and continuing disclosure[32] not so very unlike what private issuers must undertake. Not so very unlike, but not the same. In particular, the SEC does not prescribe specifics as to what must be contained in the disclosure nor must the disclosure be pre-registered.[33] Because public officials can often be presumed to be pursuing public rather than private ends, there is some justification for this approach.[34]

The municipal marketplace has arguably been well served by this light touch regulation. The market is large and has produced a vast amount of infrastructure.[35] Furthermore, despite some bad press, there have still been few municipal defaults and bankruptcies.[36] Nevertheless, the SEC itself has assessed the secondary municipal

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[31] *See* Securities Act of 1933 § 17(c); Securities Exchange Act of 1934 § 10(b); 17 C.F.R. § 240.10b-5 (2013) (rule formulated by the SEC).

[32] 17 C.F.R. § 240.15c2-12 (detailing disclosure including notice and statements requirements regarding municipal securities); *see also* Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others, 59 Fed. Reg. 12,748, 12,748–58 (interpretation effective Mar. 9, 1994) (codified at 17 C.F.R. pts. 211, 231, 241). Technically, the requirement falls on municipal security underwriters, but the underwriters will not proceed unless the issuer promises to comply and so this is largely a distinction without a difference. *See* Securities Exchange Act of 1934 §§ 15B(d)(2), (e)(4).

[33] *See* 17 C.F.R. § 240.15c2-12.

[34] AMDURSKY & GILLETTE, *supra* note 15, § 6.1.1, at 316–17 (arguing that "officials involved in the process are presumably pursuing public, rather than personal, welfare").

[35] SEC, REPORT ON THE MUNICIPAL SECURITIES MARKET, *supra* note 25, at 1; *see also* Isabel Rodriguez-Tejedo & John Joseph Wallis, *Fiscal Institutions and Fiscal Crises*, *in* WHEN STATES GO BROKE: THE ORIGINS, CONTEXT, AND SOLUTIONS FOR THE AMERICAN STATES IN FISCAL CRISIS 9, 10 (Peter Conti-Brown & David A. Skeel, Jr. eds., 2012) ("In the first decade of the twenty-first century, state and local governments combined borrow roughly $300 billion a year to finance capital and infrastructure investments.").

[36] SEC, REPORT ON THE MUNICIPAL SECURITIES MARKET, *supra* note 25, at 22–26 (finding that municipal securities have a small rate of default and that municipal bankruptcies are also rare); *see also* Rodriguez-Tejedo & Wallis, *supra* note 35, at 10 ("American state and local governments rarely default (in the sense of missing interest payments).").

market as "illiquid and opaque."[37] The primary market is no better; the quality of disclosure varies widely and there are high transaction costs involved in collecting and assessing disparate data.[38]

Both Congress and the SEC are aware of the issues. On its own, the SEC has launched several helpful initiatives, including requiring the submission of all disclosure documents to a centralized repository, the Electronic Municipal Market Access system ("EMMA").[39] Furthermore, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act" or "Dodd-Frank")[40] also made important changes, including creating a new category of regulated person, a "municipal advisor," and imposing a fiduciary duty on municipal advisors as to their municipal clients.[41]

One response to such steps might be: wait, it took until 2008 for there to be a central place to find municipal disclosure? And, whoa, you mean municipal advisors did not have a fiduciary duty to their clients *before* Dodd-Frank? But that is where this market has been, and it has, I believe, a long way to go. Indeed, the SEC itself has proposed a large number of reforms, including reforms to the municipal disclosure obligation that would bring municipal

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[37] SEC, REPORT ON THE MUNICIPAL SECURITIES MARKET, *supra* note 25, at v.

[38] *See Lowering Borrowing Costs for States and Municipalities Through CommonMuni*, POLICY BRIEF (The Hamilton Project, D.C.), Feb. 2011, at 1–2, *available at* http://brookings.edu/~/media/research/files/papers/2011/2/municipal%20bond%20ang%20green/02_municipal_bond_ang_green_brief.pdf (detailing the problem); Philip Grommet, *A Call for Action: An Analysis of the Impending Regulatory Crisis in the Municipal Securities Market*, 38 J. LEGIS. 237, 250–54 (2012) (same).

[39] EMMA, http://emma.msrb.org/AboutEmma/Overview.aspx (last visited Apr. 16, 2014) ("The Electronic Municipal Market Access (EMMA) website was established to increase the broad comprehensive access to vital disclosure and transparency information in the municipal securities market.").

[40] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"), Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 7, 12, and 15 U.S.C.).

[41] *See* 15 U.S.C. § 78o-4(a)(1)(B) (2012) (imposing fiduciary duties on municipal advisors); *see also* Registration of Municipal Advisors, 78 Fed. Reg. 67,468 (Nov. 12, 2013) (to be codified at 17 C.F.R. pts. 200, 240, 249) (establishing the final rule on the registration of municipal advisors); *Request for Comment on Draft MSRB Rule G-42, on Duties of Non-Solicitor Municipal Advisors*, MUN. SEC. RULEMAKING BD. (Jan. 9, 2014), http://msrb.org/~/media/Files/Regulatory-Notices/RFCs/2014-01.ashx?n=1.

disclosure more in line with private disclosure.[42] And we must remember that it is not as if the private securities marketplace has functioned superbly.[43]

Imposing a higher standard of disclosure on municipal issuers will almost surely require further congressional action.[44] It is, of course, not likely that such legislation will be forthcoming. Given that this is so, what results? First, most obviously, the case that creditors will be able to monitor local government financial practices is weakened in proportion to the extent that the municipal marketplace is not working as well as the private marketplace. For instance, municipal creditors are less likely than private creditors to receive regular and standardized disclosure about the fiscal health of issuers.[45] Note that, even if the municipal marketplace were working as well as the private marketplace, one might still have reservations about over-reliance on creditor monitoring because, for example, creditors can diversify themselves against risk, but the inhabitants of individual localities cannot.[46]

Second, it is still in the best interest of a state—or states—to improve their corners of the municipal marketplace. The gaps left by federal law and regulation provide a roadmap of worthwhile areas for state action. For instance, a state can require its localities to provide standardized, rigorous, and updated disclosure.

Third, we should note the somewhat curious conceptual road we have traveled. As explained in the introduction, the classic argument in this area is between those who look for more state regulation and those who think creditors do—or can do—a better

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[42] *See* SEC, REPORT ON THE MUNICIPAL SECURITIES MARKET, *supra* note 25, at viii–x.

[43] *See, e.g.*, Ronald J. Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 J. CORP. L. 715, 736–37 (2003) (cataloguing reasons that market intermediaries in particular fail to perform their function).

[44] *See* Grommet, *supra* note 38, at 276 ("Congress should improve the statutory authority for municipal securities regulatory enforcement so that primary market disclosure can be lawfully compelled by regulators.").

[45] *See, e.g.*, CA. DEBT INV. AND ADVISORY COMM'N, MUNICIPAL MARKET DISCLOSURE: CAFR FILINGS 2, *available at* http://treasurer.ca.gov/cdiac/publications/cafr.pdf (finding about 70% of issuers filed key continuing disclosure document on-time, with about 10% of issuers not filing document at all).

[46] *See* Richard Schragger, *Citizens Versus Bondholders*, 39 FORDHAM URB. L.J. 787, 792 (2012).

job.[47] Yet the ability for creditors to succeed is reliant on a robust regulatory regime at the federal level.[48] Gaps in this regime undermine the ability of creditors to do their job as monitors and, thus, if we are to rely on private creditors as opposed to state monitors, then we need the state to step in and help the municipal marketplace.

III. The Federal Tax Laws

As a matter of institutional design, it always made sense for the central government to regulate the sale of securities as such because such a national market is a national public good.[49] It is less clear that there is a necessary role for federal tax regulation in the sale of municipal securities. Yet the IRS plays a very large role.[50] To a significant degree, this role is just an accident of history. When the federal income tax was introduced in 1913, it was not clear, as a matter of law, that the federal government could tax the interest earned on securities issued by state and local governments.[51] Once

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[47] *See* Gillette, *supra* note 14, at 639 (discussing the monitoring role of different actors in the municipal securities market).

[48] SEC, REPORT ON THE MUNICIPAL SECURITIES MARKET, *supra* note 25, at 133–38.

[49] Indeed, this seems be just one way that the federal government acts to stabilize local finances. Expansionary spending during recessions is another way. *Cf.* Schragger, *supra* note 46, at 798 ("The paucity of full-scale municipal defaults—at least in the latter half of the twentieth century—might instead be attributed to the emergence of the federal government as a stabilizing force. The federal government serves two roles with respect to sub-federal jurisdictions. First, the federal government plays an important regulatory role, policing the credit markets (at least to some extent) and limiting (if not eliminating) corruption. Second, the federal government has taken on the bulk of redistributive spending. Local governments receive direct aid from the federal government. More important is the aid that flows to individuals through federal social welfare programs. The rise of the social welfare state means that economic downturns do not necessarily lead to economic collapse. The boom and bust cycle is ameliorated by large-scale national social welfare spending.").

[50] *See infra* notes 51–78 and accompanying text.

[51] This history is recounted at greater length in *How Less Can Be More: Using the Federal Income Tax to Stabilize State and Local Finance*. Shanske, *supra* note 6, at 434–35.

granted, this benefit of tax exemption was, of course, vigorously defended.[52]

The benefit was also abused. Two abusive practices stand out. [53] First, states were issuing more bonds than they needed at tax-exempt interest rates and then earning arbitrage by investing that money in a different safe, but not tax-free, investment, such as US Treasuries. Second, the states were borrowing at a tax-exempt rate to aid private businesses. In essence, this second practice meant that all the taxpayers in the US were subsidizing the industrial policy of a particular state. It should also be noted that the value of the exemption for all projects is whittled away as more tax-exempt bonds are issued.

Both the practice of earning of arbitrage through the tax exemption and the support of state industrial champions were curtailed by the Tax Reform Act of 1986 ("Tax Code").[54] Curtailed, but not forbidden altogether, and for good reason. After all, there are clearly many projects worthy of the federal tax exemption that benefit some private parties.[55] Furthermore, municipalities should be able to earn some interest on their municipal bond proceeds while a project is under construction.[56] Yet these boundaries need to be patrolled, and, since this subsidy for local infrastructure is administered through the Tax Code, it falls to the IRS.

And this brings us to the argument that, though accidental, the current responsibilities of the IRS are not wholly inappropriate. There is clearly a place for the federal subsidization of state and local infrastructure. These pieces of infrastructures are at least partly public goods, and there is a strong likelihood that the positive

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[52] *See, e.g.*, JEFFREY H. BIRNBAUM & ALAN S. MURRAY, SHOWDOWN AT GUCCI GULCH (1987) (battle over 1986 Tax Reform Act); NAT'L ASS'N OF BOND LAWYERS, TAX-EXEMPT BONDS: THEIR IMPORTANCE TO THE NATIONAL ECONOMY AND TO STATE AND LOCAL GOVERNMENTS (Sept. 2012), *available at* http://nabl.org/uploads/cms/documents/NABL_White_Paper.pdf (recent example of industry lobbying).

[53] Shanske, *supra* note 6, at 441–43.

[54] Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C.); *see* Michael Stanton, *Study: Arbitrage Rebate Rules Stopped Billions in Excess Issuance Since 1986*, BOND BUYER, Mar. 17, 1997, at 4, 4 ("The arbitrage rebate rules instituted as part of the Tax Reform Act of 1986 have successfully reduced the amount of tax-exempt bonds outstanding since then . . . .").

[55] *See* I.R.C. §§ 103, 141 (2012) (defining private activity bond).

[56] *See id.* §§ 103, 148 (defining arbitrage bond).

externalities produced (or negative externalities mitigated) extend beyond a particular jurisdiction.[57] Without a central government subsidy, therefore, these goods might be underproduced.[58]

Now, this subsidy need not be administered through the Tax Code, and indeed the federal government does spend on state and local infrastructure directly.[59] Still, the tax exemption has definite arguments in its favor. First, the tax exemption leaves a great deal of initiative with the state and local governments, which we may reasonably believe are likely to have a better sense of what is needed. Second, and relatedly, the tax exemption makes financing cheaper, but it is not free and so the state and local governments will still have a lot of incentive to spend money wisely. This is especially true because, at least roughly, state and local governments still operate under a hard budget constraint.[60] The tax exemption will not save the local government from a default. Third, the IRS has turned out to be a fairly efficient enforcer of these rules.[61] Issuing simply to earn arbitrage or aid a local business is now much rarer.

What can we learn about the success of the federal role here? It is particularly perplexing that the federal government seems to have been somewhat successful where state constitutional law has failed—or at any rate has been long abandoned. I think that the key lesson is institutional. I do not think there is something special about the IRS or about regulating these issues at the federal level. I think that what is essential is that the federal regulatory regime has worked through a series of statutory rules, regulations, administrative rulings, and resulting industry practices. This is in contrast to the disfavored state constitutions that operate by means of sweeping—and vague—prohibitions that could only be slowly fleshed out by means of a common law process presided over by generalist judges.

Given the porousness of the disfavored constitution, and the importance of the federal tax exemption for municipal borrowing,

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[57] *See* Gillette, *supra* note 3, at 105–06.

[58] Amdursky & Gillette, *supra* note 34, § 1.1, at 2–12.

[59] *See, e.g.*, *Resources for Government*, U.S. DEP'T OF TRANSP., http://dot.gov/resources/government (last visited Apr. 16, 2014) (listing federal funding available for state and local government projects).

[60] David Gamage & Darien Shanske, *The Trouble with Tax Increase Limitations*, 6 ALB. GOV'T L. REV. 50, 63 (2013).

[61] *Cf.* David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 972–82 (2004) (arguing that the IRS can have a competitive advantage in administering certain "spending" programs).

the thinking of the IRS as to fairly abstract matters of state political organization can become fairly important. This Article presents a recent example[62]—the consequences of this non-precedential IRS action have not yet been fully digested by the marketplace (or, perhaps even, by the IRS).

State law has long provided a mechanism for local governments to create sublocal units for the purpose of development.[63] In a typical example, a general-purpose government, like a county, will create a special district on a piece of undeveloped land.[64] The new district will be responsible for collecting assessments (or taxes) levied solely on that land and then issuing bonds to pay for the infrastructure that land will need in order to be developed.[65] These bonds are typically tax-exempt, a major advantage for a private developer.[66] Also, the required payment for the bonds is imposed on the future residents of the district going forward and not on the developer, another big advantage.[67] The formation of these special districts is thus typically developer driven.

I have argued elsewhere that these developments are often not a proper use of the federal (or state) tax subsidy because, among other reasons, this kind of financing makes it much easier to finance sprawl pattern development.[68] Only undeveloped land can be financed in this cheap manner because otherwise new taxes or assessments will be subject to voter approval, which is hard to get.[69] I have also argued that, as a matter of current law, the Treasury Regulations are too lax in allowing a great deal—too much—of the

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[62] *See infra* notes 73–77 and accompanying text.
[63] Darien Shanske, *Public Tax Dollars for Private Suburban Development: A First Report on a National Phenomenon*, 26 VA. TAX REV. 709, 711–13 (2007).
[64] I describe these districts in greater detail in *Public Tax Dollars for Private Suburban Development*. *Id.* at 721–45 (discussing Mello-Roos Tax bonds).
[65] *Id.* at 711.
[66] *See supra* note 20 and accompanying text.
[67] *See id.* at 765 (stating that taxes used to fund municipal securities "frustrate[] the will of future majorities").
[68] Darien Shanske, *Above All Else Stop Digging: Local Government Law as a (Partial) Cause of (and Solution to) the Current Housing Crisis*, 43 U. MICH. J.L. REFORM 663, 669 (2010).
[69] *See id.* at 704.

federal tax benefit to inure to a private party (the developer).[70] So far, these concerns have not gotten anywhere, until recently—perhaps.

Another typical pattern for this form of development/tax exempt financing is that the special district will be organized in such a way that the developer retains a great deal of control until the district is "built out"—at that point, the local residents and taxpayers will take over.[71] In Florida, one particular district was designed such that the developer would never cede control because the district had been formed in the commercial core of a much larger project.[72] There would never be very many residents in this core and thus the developer would retain control.

Rather than ask whether the development was too "private" to merit an exemption under the rules of section 141 of the Tax Code, the IRS asked whether this district was sufficiently "governmental" to satisfy section 103.[73] The answer was "no" because the issuer "was organized and operated to perpetuate private control and avoid indefinitely responsibility to a public electorate, either directly or through another elected [s]tate or local governmental body."[74] It is not clear how important this piece of non-precedential advice will turn out to be. Arguably, not very important, especially because, as noted above, special districts in these kinds of financings are usually not governed by a private developer in perpetuity.[75] On the other hand, such structures are apparently not unheard of, and, in any event, the mere fact that the IRS is showing greater interest in the "governmentality" of these districts[76] is a matter that needs to be disclosed under federal securities law—and it is not clear how much of this risk the market will tolerate, or at what cost. Indeed, it is interesting that two of the

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[70] *See generally* Darien Shanske, *Attention Carbon Auditors: There's Low-Hanging Fruit in the PAB Regs*, 127 TAX NOTES 685 (2010).

[71] Lynn Hume & Shelly Sigo, *IRS Ruling Against Fla. CDD May Have Limited Reach*, BOND BUYER (June 6, 2013, 5:25 PM), http://bondbuyer.com/issues/122_109/irs-ruling-against-florida-cdd-may-have-limited-reach-1052445-1.html (illustrating that the Florida case was unusual because the district did not eventually give more control to residents).

[72] *Id.*

[73] TAM 127670-12, *supra* note 22, at 10 (considering whether the Florida district was a division of a local governmental unit).

[74] *Id.* at 12.

[75] Hume & Sigo, *supra* note 71.

[76] Ellen P. Aprill, *Municipal Bonds and Accountability to the General Electorate*, 141 TAX NOTES 547, 553 (2013).

leading cases on issuer responsibilities under the federal securities law involve disclosure of aggressive positions under the tax law.[77]

Though I have reservations about all of these financing structures, I am not certain that the IRS has hit upon the right way to limit them,[78] but right or wrong, the primary point of this example was to illustrate just how deep into issues of internal state organization and financial arrangements the IRS, by necessity, must go. This example is also an illustration, I believe, of the IRS being forced to adjudicate overly fine areas of state law because of failures of both federal and state legislators. Thus, although I think that the federal regulation of local finance through the Tax Code has actually been pretty successful, it is far from perfect and its weakness in this area is part of the reason that the IRS is floundering. The federal government should make it clear that its subsidy is only to be used for regional infrastructure, not developer-driven local projects. This would get the IRS out of the business of weighing the obscure details of local developer-driven projects. Further, states should not allow the tax exemption to be used for sprawl pattern development. This would concentrate the power of the tax exemption for the public good. It is because there is such a large number of transactions that are ill-advised and against the spirit of the federal tax exemption that the IRS is drawn into conceptual quagmires of the kind that long ago bedeviled state courts trying to enforce bans of the gift of public funds.[79]

IV. What's Missing?

Suppose that federal securities regulation of the municipal bond market were optimal. Suppose as well that the federal law governing its tax exemption were so designed that only inter-jurisdictional public goods were subsidized. Finally, suppose that state law, in broad strokes, placed reasonable limits on the use of debt. Would there still be a place for a state-level authority

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[77] SEC v. Dain Rauscher, Inc., 254 F.3d 852, 857 (9th Cir. 2001) (finding an investment banker in violation of securities laws for failure to disclose the risks of certain municipal notes); Weiss v. SEC, 468 F.3d 849, 855–56 (D.C. Cir. 2006) (finding bond counsel in violation of securities laws for misrepresenting the risk of bonds that would be taxable).
[78] Aprill, supra note 76, at 553.
[79] *See, e.g.*, Alameda County v. Janssen, 16 Cal. 2d 276 (1940); Briffault, *supra* note 19, at 910–15.

monitoring local debt finance? I believe the answer is clearly yes. There are many reasons for this conclusion, but I will focus on the one I find compelling on its own. By necessity, many (most?) local borrowers will access the credit markets rarely. In order to ensure that they spend public dollars wisely, these borrowers need expert guidance. Expert guidance, by its nature, cannot be reduced to a rule or regulation.[80] The state needs to provide the expertise for the locals to access.

V. Conclusion

Elsewhere, I have argued for the creation of state-level debt finance authorities.[81] This Article has addressed the federal role in municipal finance. Arguably, the feds should not be involved in local finance and neither should the states. Yet it turns out that the federal government does have a role (as I believe it should), and, in general, it has performed that role well. This suggests a model for how the states might implement better regulation.

It could also be argued, perhaps, that the federal government has proven so adept at regulation that there is no space remaining for the states to profitably contribute oversight. Yet we have seen that that is not the case; there is much that the federal government has left undone.[82] Indeed, even if the federal government were performing perfectly, there would still be a vital place for the states to contribute expertise.

We may put the matter another way. I think it would be generally conceded that the provision of a national market for municipal securities and a federal subsidy for municipal securities both serve to enhance local government autonomy.[83] Without these structures, localities would have a much harder time financing themselves. This autonomy-enhancing result of federal intervention follows despite the fact that the federal government works through fairly dense regulation and forbidding bureaucrats. It should thus not

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[80] What is needed is practical knowledge, which is precisely that knowledge that cannot be captured by rules. *See* ARISTOTLE, NICOMACHEAN ETHICS bk. 6, chs. 3, 6, 8 (David Ross trans., Oxford University Press 1992) (comparing practical knowledge to scientific knowledge).

[81] *See generally* Shanske, *supra* note 1.

[82] For instance, the federal government does not require regular and standardized disclosure. *See* discussion *supra* Part II.

[83] *See* Amdursky & Gillette, *supra* note 34, § 7.1, at 431.

seem too paradoxical to argue, as I have, that local governments could have their autonomy further enhanced if only they were further constrained by state-level experts on the use of debt.