but a study of IDB use in Michigan found few diversification benefits. Little of the IDB money was used in automobile-related industries (the state's dominant industry); the bulk of the money did aid other durable-goods manufacturing facilities, which suffer much the same pattern of cyclical peaks and troughs as the automobile industry.

Currently, IDB use appears to be most efficiently targeted toward small businesses. The 1968 limitations drastically reduced the average size of IDB issues and concentrated their use in small- and medium-sized firms. Even here, however, targeting could be improved. The peculiar provisions of the 1968 targeting amendments, which define small businesses by capital assets rather than by sales or size of work force, allow large firms with many small, geographically dispersed facilities to benefit from IDB use. For example, a large discount retailer financed 96 stores in 19 states between 1975 and 1980 through the use of IDBs. In 1978 and 1979, 16 percent of the dollar volume of IDB sales aided companies on the Fortune 500 list of top nonindustrial firms or the Fortune 1,000 list of the largest industrial companies. On the other hand, the 1982 restrictions against IDB use by restaurants, auto dealerships, and entertainment facilities, the restrictions of many states against funding commercial facilities with IDBs, exclude large portions of the small business community from IDB financing.

Moreover, the use of a capital expenditure limit has a perverse influence on employment in the community. Many city officials and politicians are interested in small businesses, because they could generate a large number of new jobs. Here again, however, it might be more useful to categorize firms by their existing sales volume or size of work force, rather than by their capital spending. The size of capital investment stipulated by IDBs directly affects the number of jobs created. By limiting capital expenditures to $10 million, the community gains less employment for each IDB dollar than it might under another plan. For example, if cities were to use IDB financing to lure firms that plan to build facilities costing more than $10 million, the IDB program might generate more jobs. In addition, by including expenditures for three years after the IDB issue date in the capital expenditure limit, the current law could prohibit a rapidly expanding firm from building new facilities until the three-year period is over.

Conclusion: An Opportunity for Redirection

Despite the inefficiencies in the use of IDBs, Congress might wish to maintain current policy. A clear consensus on these issues is difficult to obtain, and proponents may point out that a portion of the lost tax revenues, however small, does eventually reach the various conflicting objectives of the program. But previous legislation affecting IDBs has been directed at saving money and correcting abuses, not at ensuring that this method of funding fulfills its purpose. The current debate on IDB use presents an excellent opportunity, not only to curb the impact of IDBs on federal revenues and deficits, but also to focus IDB financing more closely on federal objectives. The controversy surrounding IDB financing illustrates what is true of tax legislation more generally: an approach aimed only at the indirect prohibition of certain activities, rather than the direct encouragement of public goals, does not necessarily lead to coherent or effective policy.

Small-Issue IDBs—Tax Policy in Search of a Focus

by Paul Gary Wyckoff

Although no cash actually changes hands, a significant portion of federal government resources are being used to subsidize the activities of house-holds and private firms. This subsidy occurs rather indirectly, in the form of a loss to the U.S. Treasury when state and local governments are allowed to issue private- purpose tax-exempt bonds. According to the Congressional Budget Office, this tax loss to the federal government will total approximately $13 billion per year over the next five years. This amount is more than the federal government is expected to spend annually on highways through 1985, and more than it will spend in total for assistance to public transit systems, waste-water treatment, water resources, airports, air traffic control, and municipal water-supply systems. The single largest segment of the private-purpose, tax-exempt bond market—more than one-fifth of the total volume of new issues—is made up of small-issue industrial development bonds (see table 1). An industrial development bond (IDB) is really a corporate bond that, through the intervention of state and local govern- ments, is treated as a municipal bond for federal income tax pur- poses. The bonds are termed small- issue because they are granted tax exemption through a provision that limits their size to $10 million. Typically, a local government issues the bonds and constructs a plant or purchases equipment with the pro- ceeds. The local government in turn leases the new facilities to a private firm, using lease installments to pay off the principal and interest on the bonds. Since the interest earned on IDBs is not taxable under current law, the bond purchaser usually is willing to lend the money at lower rates than he would demand if the bonds were taxable. The credit of the issuing government is unaffected by this transaction, because the bonds are backed by the revenue of the leasing firm, not by the taxing power of the local government. If the leasing firm goes bankrupt, the issuing government is not required to pay off the bonds.

As a part of its recent effort to make a "down payment" on the federal deficit, Congress has revived the debate about federal tax incentives for business investment. In formulating new limits for small-issue IDBs, Congress has raised anew many long-standing questions about the appropriateness of IDBs as an instrument

Paul Gary Wyckoff, an economist with the Federal Reserve Bank of Cleveland, studies the public sector. The views stated herein are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.


2. At one time, a distinction was made between industrial revenue bonds and industrial development bonds, based on whether the issuing jurisdiction used its taxing authority to secure the bonds. Since local governments now only rarely back the bonds this way, the distinction has faded and the two terms have become synonymous.

Table 1 Volume of Reported Private-Purpose Tax-Exempt Bond Activity during Calendar Year 1983

| Type of bond | Total new issue$ | Student loan bonds | Private exempt entity bonds | IDBs | Multifamily rental housing | Sports facility | Convention facility | Airports, docks, wharves, and mass-transit facility | Sewage or waste-disposal facility | Pollution-control facility | Water-furnishing facility | Hydroelectric-generating facility | Mass-transmitting facility | Local district heating and cooling facility | Electric energy and gas facility | Industrial park | Small-issues Total |
|-------------|-----------------|-------------------|---------------------------|------|---------------------------|----------------|-------------------|-----------------------------------------------|-----------------------------------|---------------------------------|-----------------|------------------|----------------------|--------------------|---------------------|--------------------------|---------------|------------------|
| Total new issue$ | 3,464 | 1,691 | 2,238 | 2,147 | 5,233 | 209 | 238 | 2,346 | 1,393 | 3,834 | 87 | 97 | 17 | 86 | 1,060 | 191 | 12,634 |
| Student loan bonds | 3,464 | | | | | | | | | | | | | | | | | |
| Private exempt entity bonds | | 1,691 | | | | | | | | | | | | | | | | |
| IDBs | | | 2,238 | | | | | | | | | | | | | | | |

NOTE: Preliminary data compiled from Form 833; figures may not add to total due to rounding.

a. New issue volume equals the purchase price of the bonds minus proceeds used to refund or retire old issues.

b. No information on the amount of refunding was collected for student loan bonds.

c. Private exempt entity bonds include bonds issued for I.R.C. Section 501(c)(3) organizations—primarily the private nonprofit hospitals and educational facilities.


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As a part of its recent effort to make a "down payment" on the federal deficit, Congress has revived the debate about federal tax incentives for business investment. In formulating new limits for small-issue IDBs, Congress has raised anew many long-standing questions about the appropriateness of IDBs as an instrument.
of tax policy. This Economic Commentary discusses the history of small-issue IDBs in the United States and analyzes the debate that surrounds this controversial method of financing.

The History of IDBs

Industrial development bonds were first used in the United States in 1936, when the state of Mississippi established a Balance Agriculture Program with the assistance of the Reconstruction Finance Corporation. The goal was to encourage industrial growth and development. Since then, IDBs have been used by states, cities, and counties across the United States to finance a wide range of projects, including schools, hospitals, and transportation infrastructure.

In response to these criticisms, Congress attempted to trim IDB growth by establishing two criteria for tax-exempt purpose—purpose and size. The Revenue Expenditure and Control Act of 1968 revoked the tax exemption for IDBs of large size, except for quasi-public-project purposes. This exemption included airports, docks, mass transportation and parking facilities, plant and equipment for local utilities, residential housing, sewage and solid waste disposal facilities, stadiums, trade convention centers, and wharves. Also covered were bonds to finance the purchase of air- and water-pollution control equipment and bonds used to acquire and develop industrial parks.

In addition, the 1968 act allowed all IDBs of less than $1 million to retain their tax-exempt status, and these bonds became known as small-issue IDBs. Subsequent amendments to the act raised the ceiling on small-issues to $5 million, and then to $10 million, but stipulated that a first-time receiving the tax exemption on an issue greater than $1 million must not spend more than $10 million on capital facilities in the issuing jurisdiction. Projects funded with the assistance of Urban Development Action Grant money may spend $20 million. The $10 million limit applies to the firm’s total expenditures (not just those financed by the bond on plant and equipment) in six years, beginning three years prior to the issuance of the IDB. By amending the capital facilities in the issuing jurisdiction. Projects funded with the assistance of Urban Development Action Grant money may spend $20 million.

After the 1968 law was passed, IDB sales took a nosedive and then began to climb upward again, partly because issuers began to recognize the breadth of activities that could be financed under the small-issue exemption. From its traditional use to support industrial activities, IDB financing spread increasingly to commercial and retail projects. Reports of IDBs being used to finance massage parlors, racquet clubs, and race tracks tracks motivated Congress to include additional trimming measures in the Tax Equity and Fiscal Responsibility Act of 1982.

This law restricted IDB financing for automotive dealerships, recreation and entertainment facilities, and restaurants, requiring for the first time that IDB issues be reported to the Internal Revenue Service. In addition, specific recreation and entertainment facilities, including the three listed above, were entirely prohibited from IDB use. Congress also enacted a sunset provision that would remove the tax-exempt status for $20 million, whichever is greater. In addition, no significant revenues are generated from IDBs, since all 50 states have IDB sales prior to 1984. In fact, based on CBO estimates of IDB sales from 1975 to 1980, there is a positive and significant correlation in most states for tax-exempt bonds.

Finding a Targeted Problem: Small-Issue IDB Use

IDBs as national policy. Suppose for a moment that the federal government wanted only about the nation’s aggregate income and employment and not about their geographic distribution. As a national policy, it would be difficult to justify the use of IDBs because there are more efficient ways to reach the various goals for which IDBs were established. For example, if the goal is to stimulate business investment, a tax-exempt issue of $20 million would not be an efficient way to reach this goal.

As part of its effort to reduce the federal deficit, Congress recently approved further tightening provisions of the Internal Revenue Code. This provision limits the combined volume of IDBs and student loans that may be issued in each state to $150 million per year.6 The $150 million limit applies to the firm’s total expenditures (not just those financed by the bond on plant and equipment) in 1975 to 1984. In fact, IDB financing spread increasingly to commercial and retail projects.

In response to these criticisms, Congress attempted to trim IDB growth by establishing two criteria for tax-exempt purpose—purpose and size. The Revenue Expenditure and Control Act of 1968 revoked the tax exemption for IDBs of large size, except for quasi-public-project purposes. This exemption included airports, docks, mass transportation and parking facilities, plant and equipment for local utilities, residential housing, sewage and solid waste disposal facilities, stadiums, trade convention centers, and wharves. Also covered were bonds to finance the purchase of air- and water-pollution control equipment and bonds used to acquire and develop industrial parks. In addition, the 1968 act allowed all IDBs of less than $1 million to retain their tax-exempt status, and these bonds became known as small-issue IDBs. Subsequent amendments to the act raised the ceiling on small-issues to $5 million, and then to $10 million, but stipulated that a first-time receiving the tax exemption on an issue greater than $1 million must not spend more than $10 million on capital facilities in the issuing jurisdiction. Projects funded with the assistance of Urban Development Action Grant money may spend $20 million. The $10 million limit applies to the firm’s total expenditures (not just those financed by the bond on plant and equipment) in 1975 to 1984.

In order to determine if this target is feasible, the author of this commentary has analyzed data on IDB sales from 1975 to 1980 and found that there is a positive and significant correlation in most states for tax-exempt bonds. In fact, based on CBO estimates of IDB sales from 1975 to 1980, there is a positive and significant correlation in most states for tax-exempt bonds.
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As part of its effort to reduce the federal deficit, Congress recently approved further tightening provisions, one of which limits the combined volume of IDBs and student-loan bonds that may be issued in each state to $200 million, whichever is greater, beginning three years prior to the issuance of the IDB. By 1989, the total volume of small-issue IDBs, beginning in 1987.

Finding a Target: Problems in Small-Issue IDB Use. IDBs as national policy. Suppose for a moment that the federal government cared only about the nation’s aggregate income and employment and not about their geographic distribution. As a national policy, it would be difficult to justify the use of IDBs because there are more efficient ways to reach the various goals for which IDBs were established. For example, if the goal is to stimulate business investment generally, targeting the funds through an investment-tax credit would produce a much greater reduction in the cost of investment capital without changing the revenue loss to the U.S. Treasury. Much of the money lost through IDBs simply reduces the taxes of high-income taxpayers, and only the marginal tax bracket would be indifferent between taxable and tax-exempt bonds. Anyone with a marginal tax rate higher than 25 percent would purchase tax-exempt bonds and would receive a tax subsidy, in the sense that he or she would be paid an interest rate higher than necessary to ensure purchase of the tax-exempt securities. Or, to put it another way, purchasing the bonds would enable anyone in these higher tax brackets to lower his or her tax rate to 25 percent (the interest foregone on the tax-exempt securities).

Since the exact income distribution of IDB recipients is unknown, the precise amount of this slippage is impossible to calculate, but it is possible to use the available data on the revenue losses from IDBs, the Congressional Budget Office suggests that the average small-issue IDB investor has a marginal tax rate that is close to 40 percent. This means that, in this example, three-eighths of the revenue lost through IDBs would be divided by the taxpayer’s marginal tax rate to yield 40 percent, and only the remaining five-eighths benefits firms in the form of lower interest costs. In other words, the revenue was not spent by these higher tax-bracket investors, but was spent by the marginal taxpayers and would enable anyone in these higher tax brackets to lower his or her tax rate to 25 percent (the interest foregone on the tax-exempt securities).

The Howl of IDBs. Industrial development bonds were first used in the United States in 1936, when the state of Mississippi established a Balance Agriculture with Industry program that used the borrowing power of state and local governments to attract distressed rural areas. Industrial development bonds were originally targeted to attract businesses to areas with high unemployment and depressed economies, while also restricting IDB use to support industrial activities, IDB financing spread increasingly to commercial and retail projects. Reports of IDBs being used to finance massage parlors, racquet clubs, and race tracks motivated Congress to include additional tightening measures in the Tax Equity and Fiscal Responsibility Act of 1982. This law restricted IDB financing for automobile dealerships, recreation and entertainment facilities, and restaurants, requiring for the first time that IDB issues be reported to the Internal Revenue Service. In addition, specific recreation and entertainment facilities, including the three listed above, were entirely prohibited from IDB use. Congress also enacted a sunset provision that would remove the tax-exempt status from all small-issue IDBs, beginning in 1987.

But the Howl of IDBs was passed, IDB sales took a nosedive and began to climb upward again, partly because issuers began to recognize the breadth of activities that could be financed under the small-issue exemption. From its traditional use to support industrial activities, IDB financing spread increasingly to commercial and retail projects. Reports of IDBs being used to finance massage parlors, racquet clubs, and race tracks motivated Congress to include additional tightening measures in the Tax Equity and Fiscal Responsibility Act of 1982. This law restricted IDB financing for automobile dealerships, recreation and entertainment facilities, and restaurants, requiring for the first time that IDB issues be reported to the Internal Revenue Service. In addition, specific recreation and entertainment facilities, including the three listed above, were entirely prohibited from IDB use. Congress also enacted a sunset provision that would remove the tax-exempt status from all small-issue IDBs, beginning in 1987.

To reduce transactions costs, most IDBs are privately placed with banks and other local investors, not sold on organized exchanges. Short-term contact of such as these is individually established the magnitude of IDB sales prior to 1982 is lacking and way of determining the severe has hampered research into the impact of IDBs in a variety of areas, including interest rates.
but a study of IDB use in Michigan found few diversification benefits. Little of the IDB money was used in automobile-related industries (the state's dominant industry); the bulk of the money did aid other durable-goods manufacturing facilities, which suffer much the same pattern of cyclical peaks and troughs as the automobile industry.

Currently, IDB use appears to be more efficient in targeting toward small businesses. The 1968 limitations drastically reduced the average size of IDB issues and concentrated their use in small- and medium-sized firms. Even here, however, targeting could be improved. The peculiar provisions of the 1968 targeting amendments, which define small businesses by capital assets rather than by sales or size of work force, allow large firms with many small, geographically dispersed facilities to benefit from IDB use. For example, a large discount retailer financed 96 stores in 19 states between 1975 and 1980 through the use of IDBs. In 1978 and 1979, 16 percent of the dollar volume of IDB sales aided companies on the Fortune 500 list of top nonindustrial firms or the Fortune 1,000 list of the largest industrial companies. On the other hand, the 1982 restrictions against

7. See CBO, Small Issue Industrial Revenue Bonds, pp. 70-71. CBO data for these 6 years provided 271 observations. The correlation between per capita income and IDB use was 0.273 and was significant at the 1 percent level. The correlation between unemployment rate and IDB volume was 0.022, which was not significant at even the 10 percent level. The pattern of these results was unchanged, even when the state of Michigan was excluded (by far the largest user of IDBs in this period) from the analysis.


IDB use by restaurants, auto dealerships, and entertainment facilities, and the restrictions of many states against funding commercial facilities with IDBs, exclude large portions of the small business community from IDB financing.

Moreover, the use of a capital expenditure limit has a perverse influence on employment in the community. Many city officials and politicians are interested in small businesses, because they could generate a large number of new jobs. Here again, however, it might be more useful to categorize firms by their existing sales volume or size of workforce, rather than by their capital spending. The size of capital investment stimulated by IDBs directly affects the number of jobs created. By limiting capital expenditures to $10 million, the community gains less employment for each IDB dollar than it might under another plan. For example, if cities were to use IDB financing to lure firms that plan to build facilities costing more than $10 million, the IDB program might generate more jobs. In addition, by including expenditures for three years after the IDB issue date in the capital expenditure limit, the current law could prohibit a rapidly expanding firm from building new facilities until the three-year period is over.

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Despite the inefficiencies in the use of IDBs, Congress might wish to maintain current policy. A clear consensus on these issues is difficult to obtain, and proponents may point out that a portion of the lost tax revenues, however small, does eventually reach the various conflicting objectives of the program. But previous legislation affecting IDBs has been directed at saving money and correcting abuses, not at ensuring that this method of funding fulfills its purpose. The current debate on IDB use presents an excellent opportunity, not only to curb the impact of IDBs on federal revenues and deficits, but also to focus IDB financing more closely on federal objectives. The controversy surrounding IDB financing illustrates what is true of tax legislation more generally: an approach aimed only at the indirect prohibition of certain activities, rather than the direct encouragement of public goals, does not necessarily lead to coherent or effective policy.

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