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

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Although no cash actually changes hands, a significant portion of federal government resources are being used to subsidize the activities of households 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 1989, and more than it will spend *in total* for assistance to public transit systems, wastewater treatment, water resources, airports, air traffic control, and municipal water-supply systems.[1]

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 governments, is treated as a municipal bond for federal income tax purposes.[2] 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 proceeds. 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 longstanding questions about the appropriateness of IDBs as an instrument

Table 1 Volume of Reported Private-Purpose Tax-Exempt Bonds in 1983
By type of activity; in millions of dollars

Type of bond	Total new issues[a]
Student loan bonds[b]	3,464
Private exempt entity bonds[c]	8,231
IDBs:	
Multifamily rental housing	5,253
Sports facility	209
Convention facility	238
Airports, docks, wharves, and mass-commuting facility	2,147
Sewage or waste disposal facility	1,393
Pollution-control facility	3,834
Water-furnishing facility	87
Hydroelectric-generating facility	59
Mass-commuting vehicle	17
Local district heating and cooling facility	86
Electric energy and gas facility	1,060
Industrial park	191
Small-issues	13,514
TOTAL	39,784

NOTE: Preliminary data compiled from Form 8038; 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 earlier 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—principally private nonprofit hospitals and educational facilities.

SOURCE: U.S. Department of the Treasury, Office of Tax Analysis, *Treasury Report on Private Purpose Tax-Exempt Bond Activity during Calendar Year 1983*, March 28, 1984, table 2.

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1. See Alice M. Rivlin's 1983 testimony before House Ways and Means Committee, reproduced in Alice M. Rivlin, "CBO's Position on Tax-Exempt Financing for Private Activities," *Municipal Finance Journal*, vol. 4, no. 4 (Fall 1983), p. 303.

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 in this way, the distinction has faded and the two terms have become synonymous.

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 with Industry program that used the borrowing power of state and local governments to diversify its Depression-stricken, agricultural-based economy. Use of the bonds spread slowly, however; by 1950, only Alabama, Kentucky, and Mississippi had authorized their issuance. In the 1960s, IDB financing became popular and spread to the East and the Midwest, where it was embraced as a means of attracting new industries and preventing old ones from moving to the Sunbelt. By 1968, the volume of IDBs issued had climbed to $1.8 billion.

The growth in volume of the bonds caused concern in Congress, for three reasons. During the 1960s, the loss to the U.S. Treasury through the tax exemption was considerable. Also, there was alarm that IDBs threatened the market for more traditional public-purpose municipal bonds (like those used for schools and highways) by driving up interest rates on all municipal issues. Third, the average size of the issues had expanded dramatically, from $366,000 in 1957 to $7.8 million a decade later.[3] Even after being adjusted for inflation, these figures represented a 17-fold increase. It became clear that large firms were reaping the tax benefits of IDBs. Policymakers believed that such firms did not need the subsidy, and that availability of IDB financing was not a major factor in where large firms chose to locate.

In response to these criticisms, Congress attempted to trim IDB growth by establishing two criteria for tax exemption—purpose and size. The Revenue Expenditure and Control Act of 1968 revoked the tax exemption for IDBs of large size, except for quasi-public-purpose projects. This exemption includes airports, docks, mass transportation and parking facilities, plant and equipment for local utilities, residential housing, sewage and solid waste disposal facilities, stadiums, trade and convention centers, and wharves. Also covered are 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 IDB issues 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 firm receiving the assistance of 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 over six years, beginning three years prior to the issuance of the IDB. By amending the act in this way, Congress sought to provide greater help to state and local governments that were trying to develop their economies, while also restricting IDB assistance to small firms.

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 into commercial and retail projects. Reports of IDBs being used to finance massage parlors, racquet clubs, and race tracks motivated Congress to include additional trimming 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 exemption for small-issue IDBs, beginning in 1987.

As part of its effort to reduce the federal deficit, Congress recently approved further tightening provisions, one of which limits the combined volume of IDB and student-loan bonds that may be issued in each state to $150 per person or total of $200 million, whichever is greater. This cap applies to all IDBs, not just small-issues, with the exception of multifamily housing issues and bonds to finance airports, convention centers, docks, transportation facilities, and wharves. However, these limitations are not as restrictive as they might seem. The two-part nature of the cap appears to guarantee that almost all states will be able to issue the same volume of

3. See Susan R. Robertson, "Industrial Development Bonds: They're Not What They Used to Be," *Business Review*, Federal Reserve Bank of Philadelphia (March 1969), p. 4.

bonds as before, so the legislation affects only the future rate of growth of IDBs. Moreover, bonds that are sold by the end of 1984 for projects approved before June 19, 1984, are exempt from the provision. As a final weakening measure, Congress excluded manufacturing projects from the sunset provision of 1982, prolonging the tax-exempt status of these bonds until 1989.

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, without affecting investment. Suppose, for example, that tax-exempt issues are yielding 75 percent of the return on taxable bonds. Then a taxpayer in the 25 percent 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 investors is unknown, the precise amount of this slippage is impossible to calculate, but it is possibly quite large. In its analysis of 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.[4] This means that, in this example, three-eighths of the revenue lost through IDBs (25 percent divided by the taxpayer's 40 percent tax rate) benefits high-income taxpayers, and only the remaining five-eighths benefits firms in the form of lower interest costs.

In addition to revenue losses and inefficient stimulation of investment nationally, IDB financing detracts from the ability of local governments to raise funds for traditional projects such as roads, schools, and sewers. By drawing borrowers away from the taxable into the tax-exempt market, IDBs and other private-purpose bonds increase the competition for funds in the municipal market and drive up municipal interest rates. This "crowding out" effect is potentially serious. In 1983, private-purpose bonds accounted for 68 percent of the total volume of long-term, tax-exempt issues, with small-issue IDBs alone making up 15 percent of this total.[5] However, partly because Congress did not require reporting of the bonds until 1982, the magnitude of this interest-rate effect is not known.[6]

Regional targeting. On the other hand, IDBs might be considered as part of some *regional* policy, intended to favor certain firms and certain parts of the country. In the course of the debate over IDBs, advocates have argued that the bonds benefit rural communities, economically distressed regions, areas trying to diversify their industrial base, and small businesses. However, it is doubtful whether these groups are favored over others, since all 50 states have authorized IDBs, and the federal government has made few legislative efforts to target the funds.

For example, there is no system among communities using IDBs to ensure that distressed areas receive all or even most of the aid provided by IDBs. In fact, based on CBO estimates of IDB sales from 1975 to 1980, there is a positive and significant correlation between IDB sales in a specific state and state per capita income. In addition, no significant correlation exists between IDB sales and state unemployment.[7] Thus, neither of these standard measures of economic distress—income and employment—suggests that IDB dollars typically find their way into economically disadvantaged states. On the other hand, it could be that IDBs are used disproportionately by the most distressed areas within each state, so that these statewide correlations are misleading. This seems unlikely, however, since only a few states direct their IDB funds to economically troubled areas.

Similarly, IDBs were originally intended to diversify local economies,

4. See Congressional Budget Office, *Small Issue Industrial Revenue Bonds*, Washington: U.S. Government Printing Office, September 1981, p. 41, n. 5.

5. See U.S. Department of the Treasury, Office of Tax Analysis, *Treasury Report on Private Purpose Tax-Exempt Bond Activity during Calendar Year 1983*, March 28, 1984, p. 2.

6. To reduce transactions costs, most IDBs are privately placed with banks and other local investors, not sold on organized exchanges. Short of contacting each of these investors individually, establishing the magnitude of IDB sales prior to 1982 is difficult. This lack of historical data 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.[8] 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.[9] 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.[10] On the other hand, the 1982 restrictions against 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 work force, 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.

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.

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 the 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 Pennsylvania (by far the largest user of IDBs in this period) was omitted from the analysis.

8. See Ann R. Thomas, "Industrial Revenue Bonds," in *Michigan's Fiscal and Economic Structure*, Harvey E. Brazer, Ed., Ann Arbor, MI: University of Michigan Press, 1982, p. 320.

9. The new law restricts this loophole somewhat by limiting the total amount a single user of IDBs may have outstanding at one time to $40 million.

10. CBO, *Small Issue Industrial Revenue Bonds*, p. 23.

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