

TAX-EXEMPT SMALL ISSUE  
INDUSTRIAL REVENUE BONDS

Statement of

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Between 1975 and 1980, CBO estimates that annual sales of tax-exempt small issue industrial revenue bonds (IRBs) rose from approximately \$1.3 billion to \$8.4 billion. The bonds are being used to fund a widening variety of projects, and their costs to the federal government are growing.

In my testimony this afternoon, I will briefly describe the uses of small issue IRBs, point out some of their potential advantages and disadvantages, and review some options the Congress may wish to consider for dealing with the IRBs in future. (All of this is discussed in greater detail in a CBO report entitled Small Issue Industrial Revenue Bonds, which was requested by the Subcommittee last year and released last week.)

Small issue IRBs are tax-exempt bonds that state and local governments issue to provide financing for private investment in plant and equipment. Because interest income from the bonds is exempt from federal taxation, they enable businesses to borrow funds at below-market interest rates. With IRBs, a government issuer transfers its tax-exempt status to a private borrower, and the federal government gives up revenues to subsidize the borrowing costs of private industry. Generally, the only backing for the bonds is the credit of the borrowing firm or the revenue from the facility financed. If the borrower defaults, the bondholder bears the loss; the result is that no matter how many IRBs a state or local government issues, its credit rating is unaffected.

#### THE EVOLUTION AND PURPOSE OF IRBS

The use of tax-exempt IRBs began in the 1930s and spread slowly, mostly in the southern states. Initially, the bonds' primary purpose was to promote industry in predominantly rural areas. For many years, the volume

of IRBs issued remained low; but beginning in the 1960s, the situation changed. Partly to compete with the sun belt, northern and midwestern states began offering IRBs for the purpose of creating and preserving jobs. By 1968, some 40 states had authorized IRB use. Large corporations began using IRBs to finance major capital expansion programs, which led the Congress to pass legislation limiting their use.

#### Current Law

The Revenue Expenditure and Control Act of 1968--which in a slightly modified form still governs the use of IRBs--reflected Congressional opposition to federal subsidies for large corporations and concern about federal revenue losses associated with IRBs. The new law withdrew the tax exemption for IRBs, with the exception of those that finance facilities or services with a quasi-public purpose, such as pollution control or sports stadiums, and those that, by virtue of their size, were designated "small issues." At no time, however, did the Congress institute any requirement for reporting IRB sales.

Limits. Under current law, small issue IRBs may be used for any private business purpose, but no single issue may exceed \$10 million. Moreover, if the issue exceeds \$1 million, total capital expenditures on all of the borrowing firm's facilities within the same county or city may not exceed \$10 million for the three years before and the three years after the issuance of a bond.

Uses. Today, 47 states issue IRBs, and more than half of these states put no restrictions on the use of the proceeds. As of 1970, most states used small issues only for manufacturing and closely related facilities.

But by the mid-1970s, state and local officials, brokers, bankers, and businessmen realized that the lack of constraints in federal law made virtually any enterprise eligible for small issue IRB financing. One state legislature after another began to pass laws relaxing or entirely removing the restrictions that earlier had confined the use of the bonds. Today, small issue IRBs finance all manner of ventures, from shopping centers to grocery stores to private sports clubs.

#### CBO's Effort to Measure Small Issue IRB Sales

Most small issues are private placements with banks or other lenders and are rarely reported beyond the state or local level. In an effort to determine the volume of small issue IRB sales, CBO requested data from all the 47 states that permit use of the bonds and from certain local agencies as well. Most states had good records, but some had incomplete information or none at all. In most cases, however, CBO was able to obtain enough information to make reasonable estimates possible. Although the volume of issues was impossible to determine precisely, CBO is confident that its estimates reflect total sales much more accurately than do the data (based primarily on public sales) that federal agencies have used in the past.

#### The Future Volume of Small Issue IRBs

Between 1975 and 1979, small issue IRBs grew at an average annual rate of 40 percent. As of January 1979, the capital expenditures limit that the 1968 law had set at \$5 million was raised to \$10 million. Partly as a result, the volume of small issues doubled in one year, increasing from \$3.5 billion in 1978 to \$7.1 billion in 1979. In 1980, however, the growth rate slowed to a much lower 18 percent.

Future growth will depend on the overall level of investment in plant and equipment, interest rate levels, the spread between conventional and tax-exempt borrowing costs, the profits of banks and casualty insurance companies (the main purchasers of small issue IRBs), and the consequent need of these institutions to offset income tax liabilities with tax-exempt holdings. At present, the secondary (that is, resale) market for unrated small issues is extremely narrow. If, however, a broader secondary market were to develop, it could greatly stimulate future growth in the volume of small issue sales.

CBO estimates that, if current law and marketing mechanisms remain unchanged, the growth in small issues could range between 10 and 20 percent a year between 1981 and 1986. Assuming the more modest 10 percent growth rate, sales in 1981 would amount to about \$9 billion, increasing to nearly \$15 billion by 1986. An average annual growth rate of 20 percent a year would result in new issues of \$10 billion in 1981, rising to \$25 billion by 1986.

#### The Effects on Federal Revenues

CBO estimates that the federal revenue losses from the use of small issue IRBs will amount to some \$1 billion in fiscal year 1981, rising to \$2.9 billion to \$3.5 billion in fiscal year 1986. The revenue gain from eliminating tax exemption on new small issue IRBs issued after July 1, 1981, would be \$300 million in fiscal year 1982, rising to between \$1.8 billion and \$2.4 billion by 1986. The net revenue gain would be less since reflow or feedback effects (lower tax collections from reduced economic activity) would offset part of the gain. These reflow effects accompany all federal

tax and spending changes, however, and are normally only taken into account when the Budget Committees consider revenue and spending totals. Unless the reflows from a change are unusually large or small--which does not appear to be the case with small issue IRBs--the average reflows reflected in the revenue and spending totals account sufficiently for these effects.

#### POLICY OBJECTIVES AND THE EFFECTIVENESS OF SMALL ISSUES

Regardless of the objectives IRBs meet, they raise a fundamental question: Under what circumstances do federal subsidies that lower the borrowing costs of private industry serve a public purpose?

Modifying the Market's Allocation of Credit. If the purpose of interest subsidies is to modify the market's allocation of credit, the Congress may continue to find small issue IRBs useful. The original purpose of the tax exemption for small issues was to enable smaller firms to benefit from lower-cost financing. Small issue IRBs have been effective in reallocating investment capital from larger to smaller firms; however, many large corporations also benefit from the subsidy.

On the other hand, firms that have difficulty qualifying for conventional financing, by and large, have no better success with IRBs. At present, less creditworthy firms can benefit from small issue IRBs only if the bonds are guaranteed by state or local agencies. Small issues themselves do not offer last-resort financing.

Stimulating Investment and Employment. If the goal of federal interest subsidies is to stimulate investment and increase employment, a general business tax cut might be equally effective if not more so. If, on the other hand, the purpose of small issues is to stimulate development in

economically distressed areas, the Congress may want to consider ways to target IRBs toward specific locations or regions and to coordinate use of the bonds not only with Urban Development Action Grants (UDAG), but also with other federal credit programs.

#### POLICY ALTERNATIVES

Depending on how the Congress defines the purpose of small issue IRBs, the alternatives for legislative action range from completely eliminating tax exemption for the bonds to removing all limits on small issues. Between these extremes are several other options. These include maintaining current law or modifying it either by restricting the volume or the uses of small issues, or both, or, conversely, by relaxing current limits.

#### Maintain Current Law

If the Congress decides to take no action on small issue IRBs, the states will continue to determine the public purpose of the bonds. The Congress may decide that state and local governments, despite differences, are still in the best position to determine what public interest the bonds serve. The objection to this position most often cited is that the federal government bears the largest share of the cost of IRBs, and it therefore has the greatest stake in regulating their use.

Require Reporting. Even if it makes no general change in current law, the Congress may want to be kept apprised of the annual volume of small issue sales to make possible more accurate estimates of the cost of continuing tax exemption. If so, it could amend the law by making tax exemption conditional on the reporting of sales to a designated federal agency.

### Tighten Restrictions

Depending on its objectives, the Congress could make current law more restrictive by requiring that IRBs be targeted toward distressed areas, toward smaller businesses, or both. These objectives do not necessarily depend on requiring states to adhere to federal guidelines on targeting criteria. By setting overall limits on small issue IRB activity, by requiring states to back the bonds, or both, the Congress could make it necessary for states and localities to be more selective in their uses of IRBs. The criteria for choosing projects would still be up to the states, however.

Target IRBs to Smaller Businesses. Although current capital expenditure limits make small and medium-sized companies the most likely users of IRBs, nothing prevents large corporations from using many times \$10 million a year in IRB financing to build branch facilities across the country, so long as the investment in each facility falls within the specified capital expenditure limits. Current law works to the particular advantage of large corporations with geographically dispersed facilities. While these firms may avail themselves of unlimited amounts of tax-exempt financing, equally large firms with more concentrated facilities derive little benefit from small issues. The bonds have therefore been a boon to national retail and other firms, which require relatively low capital expenditures for each facility.

In keeping with the intent of the 1968 legislation, the Congress might want to target IRBs toward smaller businesses to facilitate their access to credit or to encourage new competition. If so, the Congress could establish



criteria for small issue IRB financing that conform to the guidelines set forth by the Small Business Administration, or it could limit the usefulness of IRBs to larger firms by setting limits on the amount of small issue financing that any given firm could use. If its goal is to make credit available to riskier firms, the Congress might want to consider coordinating the use of small issue IRBs with other public programs that offer loans, grants, or guarantees.

Target IRBs Toward Distressed Areas. Because small issue IRBs are now almost universally available, they have little effect on businesses' location decisions. If the bonds were available for use in distressed areas only, they might stimulate some additional investment where it is most needed, particularly if used in combination with other local, state, or federal programs. The criteria for determining whether or not an area qualifies as distressed could be based on state or local guidelines, or since UDAG funds are often used in conjunction with IRBs, the IRB criteria could be the same as UDAG's.

Eliminate IRBs for Commercial Projects. Although commercial projects per se may serve no less of a public purpose than industrial projects do, they have aroused more controversy at the state and local level. The Congress may therefore wish to follow the lead of those states and localities that limit the use of small issues to manufacturing and related facilities (such as North Carolina and California). If the Congress were to eliminate tax exemption on IRBs for commercial projects, investment in commercial projects would decrease wherever the market for them is not sufficiently strong to make them profitable at conventional interest rates.

CBO estimates that the overall volume of bonds would decrease by approximately 30 percent, assuming that the effect of eliminating the use of the bonds for commercial purposes would not be to reallocate capital to industrial projects.

The major federal programs that provide assistance to business do not distinguish between commercial and industrial projects, but many seek to target assistance to distressed areas. Eliminating tax exemption on small issues for commercial projects would prevent the use of these interest subsidies in combination with some UDAG projects. It could also have adverse effects on state and local programs that target small issues to distressed areas. For these reasons, the Congress may wish to limit small issues for commercial projects to distressed areas, or require that the states do so.

Set a Limit on State IRB Sales. In order to permit the states to target the use of small issues as they see fit, rather than require them to follow federal criteria, the Congress might simply impose a state-by-state dollar per capita limit on small issue sales. In 1980, small issue sales per capita ranged from \$4 (in Illinois) to \$139 (in Pennsylvania). If the Congress imposed a limit of, say, \$50 per capita in each state, several states would immediately have to begin using IRBs more selectively. In addition, state agencies would have to keep tabs on IRB financing activities.

Limit Tax Exempt Status to General Obligation Bonds. Another way that the Congress could leave the criteria for using small issue IRBs to the states would be to remove all current restrictions and replace them with

legislation granting tax exemption to all bonds backed by the full faith and credit of state or local government. In some states, constitutional provisions that prohibit making gifts or loans to private entities would prevent full faith and credit backing of IRBs. An alternative requirement, which would give rise to fewer legal problems, would be for the states to provide full insurance or guarantees to protect the bondholders against loss. The effect would be the same. Issuing governments would assume greater responsibility for the bonds. They and state and local voters might then consider more carefully what public purpose the bonds are serving.

Require Federal, State, or Local Matching Funds. The Congress might consider eliminating all small issue IRBs except those that also have commitments of other federal, state, or local resources. While in so doing it might be eliminating many tax-exempt financings, at the same time the Congress would be encouraging states to commit their resources to the projects that they consider most beneficial. The result might be better planning and less random use of scarce resources.

Eliminate Tax Exemption for Small Issue IRBs

If the Congress eliminated tax exemption on all small issue IRBs, some investments might not go forward. Others might move ahead, but changes in the amount and timing of investment would result. Smaller firms would be the ones most affected. Moreover, investment in distressed urban areas might decline because of the large number of UDAG projects that also receive IRB financing.

Several arguments for eliminating small issue IRBs are often raised: that, to a great extent, they reallocate capital without generating much net

new investment; that targeting criteria and volume limits are too hard to agree on and to administer; and that the public purpose of IRBs is unclear.

### Ease Restrictions

The Congress could, of course, move in the opposite direction and ease rather than tighten restrictions on small issues.

Raise the Limits. Some proponents of IRB financing have argued, with justification, that the bond ceilings and capital expenditure limits have not kept pace with inflation. The Congress raised the capital expenditure limits from \$5 to \$10 million in 1978. If, however, the \$1 and \$5 million limits that the Congress set in 1968 had kept up with inflation, they would now be about \$2.8 and \$14 million, respectively. On the other hand, the Congress has never expressly decided that the limits on small issues should keep abreast of inflation. Before making a decision, the Congress may want to evaluate the bonds' current uses.

The main beneficiaries of either raising the limits or doing away with them altogether would be larger firms. Most small issues now aid smaller firms: the average project financing in 1980 was \$1.3 million. This suggests that the current \$10 million capital expenditure limit poses no problem for most small issue beneficiaries. Only 6 percent of all 1980 small issue financings exceeded \$5 million; however, these projects accounted for more than a third of total sales. If the limits were raised, a relatively small number of larger projects would probably begin to account for most of the dollar volume of small issues. Unless demand for tax-exempt holdings were high, these firms could begin to crowd many small companies that now benefit from IRBs out of the market. Such an effect would run counter to the intent of the 1968 legislation.

Raising the limits would increase the number of projects eligible for small issues, which in turn would increase both the volume of small issues and the costs of municipal borrowing for traditional public purposes. CBO estimates that, if an increase in the capital expenditure limit to \$15 million took effect in July 1981, the volume of small issues would amount to \$16 billion in 1982 and would cost the federal government \$1.5 billion in foregone tax revenues in fiscal year 1982, rising to \$3.8 billion by 1986.

Remove Limits. Removing all dollar limits on small issue IRBs would stimulate investment and employment by lowering interest rates for a wide range of investments. The overall economic effect would be approximately equivalent to that of a general business tax cut of comparable size. Since the Congress is now considering tax legislation, it may want to weigh the merits of increases in the limits on small issue IRBs against those of other business tax cuts. One consideration is that increases in the limits on small issue IRBs would tend to raise municipal borrowing costs for traditional public-purpose projects, whereas a general business tax cut would not.