# SMALL ISSUE INDUSTRIAL REVENUE BONDS

The Congress of the United States
Congressional Budget Office

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402

NOTE

ALL DATES ARE EXPRESSED IN CALENDAR YEARS UNLESS OTHERWISE STATED

# ERRATA

## Small Issue Industrial Revenue Bonds

Appendix B should contain the following additional and revised entries:

| State | Source of Information |
|---|---|
| Kansas | The Kansas Legislative Research Department provided the results of a statewide survey conducted at the direction of the Special Committee on Assessment and Taxation. The survey obtained data on the sale of IRBs in Kansas from 1961 through mid-1980. |
| Missouri | The data were obtained from the Missouri Division of Commerce and Industrial Development. In 1978, the Missouri statutes were revised to authorize local industrial development authorities to issue bonds without state approval. No information is available on these types of issues; therefore, there is no basis on which to estimate sales volume for 1979 and 1980. The Missouri law was again amended in 1980 to allow IRB financing of commercial projects. |

Appendix C should be revised as follows:

| State | Industrial Facilities | Storage and Wholesale Distribution Facilities | Commercial Facilities | Comments |
|---|---|---|---|---|
| Nevada | x | x | --- | |
| New Mexico | x | x | x | No retail. |
| Oregon | x | x | x | Although retail use is discouraged, the state's 23 port districts may issue bonds for any purpose permitted under federal law. |

The last two sentences on page 28 should read as follows: "Among the western states New Mexico, Nevada, California, and Alaska impose restrictions on IRB use: New Mexico prohibits IRB financing for retail stores. California and Nevada restrict use of the bonds to [industrial and related facilities]."

## PREFACE

In recent months, the growing use of tax-exempt small issue industrial revenue bonds (IRBs) to fund a variety of private enterprises has drawn increasing attention. Since the use of the bonds is generally not reported beyond the state or local level, little was known about them. This paper examines the origins, current volume, and extent of small issue IRB use; the potential growth of the market; and the effects of small issues on investment and on federal revenues.

The study was prepared in response to a February 15, 1980, request from Chairman Sam Gibbons of the Oversight Subcommittee of the House Committee on Ways and Means. In accordance with the Congressional Budget Office's mandate to provide nonpartisan analysis, the paper offers no recommendations.

Pearl Richardson of the Tax Analysis Division prepared the study under the direction of James M. Verdier and with the assistance of Kathleen O'Connell and Frederick Ribe. A number of people within CBO provided valuable comments and suggestions, including Cynthia Gensheimer, Sophie Korczyk, Robert Reischauer, and the Tax Analysis Division staff. Johanna Zacharias edited the paper and Linda Brockman typed it for publication.

Many people outside CBO also assisted during preparation of the study. Without the cooperation of numerous state and local officials and other experts on tax-exempt revenue bonds, this study would not have been possible. The author wishes to express particular thanks to Michael Barker, Owen Carney, Nelson Civello, Bruce Davie, Carolyn Duncan, Deborah Ferolito, Harvey Galper, Patric Hendershott, Richard Higgins, Thomas Krebs, Larry C. Ledebur, Louis Levene, Robert Patterson, John E. Petersen, Robert Powell, Warren Richmond, Mark Rollinson, Harold Ross, Bruce Strickland, Emil M. Sunley, Jr., and Thomas Walker.

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April 1981

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## SUMMARY

Between 1975 and 1980, sales of small issue industrial revenue bonds (IRBs) increased from approximately $1.3 billion to a record high of more than $8 billion. According to new findings of the Congressional Budget Office, the use of the bonds to fund a wide variety of projects has grown rapidly in the past five years, and their cost to the federal government has increased. In light of the growing use of small issue IRBs and the revenue losses associated with them, the Congress may want to reconsider current policy on the bonds.

Small issue IRBs are tax-exempt bonds that state and local governments may issue to provide financing for private firms. In general, the only backing for the bonds is the credit of the borrowing firm, the revenue from the projects financed, or the funded facility itself. If the borrower defaults, the bondholder bears the loss, so that regardless of how many IRBs a state or local government issues, its credit rating is unaffected.

Since interest income from the bonds is exempt from federal taxation, private businesses can borrow at below-market interest rates. In effect, the federal government gives up revenues in order to subsidize the borrowing costs of private industry. CBO estimates that the federal revenue loss will amount to approximately $1 billion in fiscal year 1981, rising to between $2.9 billion and $4.4 billion in fiscal year 1986. The net revenue gain from eliminating small issue IRBs would be less, since reflow or feedback effects (lower tax collections from reduced economic activity) would offset part of the gain.

### THE EVOLUTION AND PURPOSE OF IRBS

The use of tax-exempt IRBs began in Mississippi in the 1930s and spread slowly, mostly to other 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, and the concept of their purpose shifted from promoting economic diversification to creating and preserving jobs.

By 1968, some 40 states had authorized IRB use. Large corporations began using IRBs to finance major capital expansion, with the result that between 1960 and 1968, the annual volume of reported IRB issues had risen from $100 million to $1.8 billion. The Congress responded to the surge in IRBs by passing legislation limiting their use.

Current Law

The Revenue Expenditure and Control Act of 1968--the statute that still governs IRB use--reflected Congressional concern about federal revenue losses and opposition to the federal government's offering subsidies to large corporations. The new law withdrew the tax exemption for IRBs, with the exception of those that finance quasi-public services or facilities (pollution control, airports, convention centers, parking garages, sports stadiums, and the like), and those that, by virtue of their size, were designated "small issues."

Limits. Under current law, small issues may be used for any private business purpose, but they are subject to maximum dollar limits. No state or locality may float a small issue IRB for more than $10 million. Moreover, if the bond amount 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 the bond. For a project that also has financing under the Urban Development Action Grant (UDAG) program, the capital expenditure limit is $20 million, but the tax-exempt IRB itself still cannot exceed $10 million. The law puts no other restrictions on the use of small issues, nor does it set up any framework for reporting IRB sales.

Uses. Today, 47 states issue IRBs, and more than half of these states put no restrictions on the use of the proceeds. As the number of states using the bonds has grown, so has the variety of projects benefiting from tax-exempt financing. 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 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.

Although small issues still finance industrial plants, their use for less traditional purposes is growing rapidly. Today, small issues finance all manner of ventures, from shopping centers to grocery stores to private sports clubs.

## Measuring IRB Sales

The revenue loss associated with IRBs is difficult to estimate because of problems in assessing the volume of small issue sales. Most small issues are private placements with banks or other lenders and are rarely reported beyond the state or local level. In the 1960s, unreported issues were less common because the principal beneficiaries of IRBs were large corporations, and their bonds tended to be sold publicly. Today, the situation is reversed. Since the early 1970s, the bonds have primarily (but by no means exclusively) provided financing for small and medium-sized firms. These issues substitute for conventional commercial loans, and they tend not to come into public view.

CBO's Survey. In an effort to determine the volume of small issue IRB sales, CBO requested data from all of the states that permit use of the bonds and from certain local agencies. 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 possible reasonable estimates. Although the volume of issues was impossible to determine precisely, CBO is confident that its estimates reflect total sales much more closely than do the data that federal agencies have used in the past (which were based primarily on public sales).

## POLICY OBJECTIVES AND THE EFFECTIVENESS OF SMALL ISSUES

A few years ago, when the volume of small issues was much lower and the likelihood of expansion appeared slight, IRBs drew little attention. In light of new information on the mushrooming use of small issues, the Congress may want to reevaluate current law governing IRBs. If so, the Congress will have to address basic policy issues that in the last 10 years have received virtually no attention. IRBs can serve many purposes, but they raise a fundamental question: Under what circumstances do federal subsidies to lower the borrowing costs of private industry serve a public purpose?

Stimulating Investment and Employment. If the goal of federal interest subsidies is to increase investment and employment, a general business tax cut might be equally effective if not more so. Thus, the Congress may want to weigh the costs of small issue IRBs against the costs of alternative tax measures. 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.

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. To some extent, they are effective in increasing investment among smaller firms; however, many large corporations also benefit from the subsidy.

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.

## POLICY ALTERNATIVES

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

### Remove or Raise the Dollar Limits

If the Congress were to remove all dollar limits on small issues, the effect would certainly be to stimulate investment and employment. In view of the passage of new tax legislation in

1981, the Congress may want to evaluate the costs to the federal government of increasing or removing the limits on small issue IRBs against the benefits of recently enacted business tax cuts. A general business tax cut can have as stimulating an effect on investment as lifting the ceilings on IRBs, without raising municipal borrowing rates.

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 imposed in 1968 had kept up with inflation, by mid-1981 they would have risen to $2.1 and $10.5 million, respectively. On the other hand, the Congress has never expressly decided that the limits on small issues should be indexed for inflation. Before making a decision, the Congress may want to evaluate the bonds' current uses.

The main beneficiaries of either lifting or raising the limits 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 was for more than $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 the capital expenditure limit were increased to $15 million, small issues would amount to $16 billion in 1982, and federal revenue losses would rise from $1.5 billion in fiscal year 1982 to $3.8 billion by 1986.

## Maintain Current Law

If the Congress decides to take no action, the states will continue to determine the public purpose of small issue IRBs. The

Congress may decide that state and local governments, despite differences, are still in the best position to determine what public interest small issues 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 the bonds' use.

Require Reporting. Even if it makes no changes 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 make tax exemption conditional on the reporting of sales to a designated federal agency.

### Restrict the Use of Small Issues

Depending on its objectives, the Congress could modify current law by requiring that IRBs be targeted to distressed areas, 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 activity, or by requiring state backing of the bonds, the Congress could make it necessary for the states to be more selective in their uses of IRBs; however, the criteria for choosing projects would still be up to the states.

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 ease their access to credit or to encourage new competition. If so, the Congress could establish criteria for small issue 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 a 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 issues with other federal, state, and local programs that offer loans, grants, or guarantees.

Target IRBs Toward Distressed Areas. Because small issues are almost universally available, they have little effect on businesses' location decisions. If the bonds were available for use in distresed 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 with IRBs, the criteria could be the same for both.

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. If the Congress were to eliminate tax exemption on IRBs for commercial projects, the overall volume of bonds would decrease. At the same time, investment in commercial projects would decrease wherever the market for them is not sufficiently strong to make them profitable at prevailing interest rates.

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 target small issues for commercial projects toward 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 requiring use of federal criteria, the Congress might simply impose



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a state-by-state per capita limit on small issue sales. At present, small issue sales per capita range 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 that grants tax exemption to all bonds that are 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 cause fewer legal problems, would be for the state 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, with the exception of 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.

The arguments for eliminating small issue IRBs are that to a large 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.