CHAPTER I. INTRODUCTION AND PLAN OF THE PAPER

In the past five years, the use of tax-exempt industrial revenue bonds (IRBs) to subsidize the borrowing costs of private business has increased dramatically.[1] State and local governments issue IRBs 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.[2] In effect, with IRBs, a government issuer can transfer its tax-exempt status to a private borrower.

Typically, a local government agency issues an IRB and uses the proceeds to buy or build a facility or to purchase equipment that a private enterprise will then buy on installment or lease for a period that may range from five to 30 years. The borrowing company pays a rent that is equal to the amount necessary to meet the interest and principal payments on the bonds. Once the bonds are retired, the company will either renew the lease or buy the facility for a nominal sum.

In general, the only security for the bonds is the revenue from the lease payments or the facility itself. If the tenant defaults, the bondholders bear the loss. Occasionally, the issuing body guarantees the bond or pledges its credit as security, but

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1. In common parlance, industrial development bonds (IDBs) and industrial revenue bonds (IRBs) are interchangeable terms. Both refer to bonds that are issued by public agencies to finance facilities for private enterprises. Technically, the difference between them is that IRBs are backed solely by the revenues from the project or the facility itself, while IDBs are backed by the full faith and credit of the public issuing authority. Although IDBs were the precursors of IRBs, their use has been relatively infrequent. For further background, see Mark Rollinson, Small Issue Industrial Development Bonds (Chicago: Capital Publishing Corporation, 1976).

2. The interest on state and local bonds has been exempt from federal taxation since the adoption of the income tax in 1913.

these general obligation industrial development bonds are the exception.

ORIGINS AND LIMITS OF SMALL ISSUE IRBS

The use of state and local financing to assist private industry had many precedents. During the nineteenth century, state and local governments had financed privately owned businesses, primarily canals and railroads. After the depression of the early 1840s, a number of states defaulted on bond issues. As a result, many states imposed constitutional and statutory restrictions on the freedom of local government to incur debt. Revenue bonds came into use to circumvent these restrictions. Unlike general obligation bonds, revenue bonds are backed by project facilities or the income from them, and they do not involve the extension of state credit. Revenue bonds finance publicly owned facilities such as bridges, ports, and turnpikes. Industrial revenue bonds finance construction of facilities for lease or sale to private concerns.

The use of IRBs began in the 1930s and spread slowly, mostly in southern states. In the 1960s, use of IRBs became more widespread. In 1968, when reported issues reached a total of $1.8 billion, the Congress became concerned about the federal revenue losses associated with the bonds; it therefore passed legislation limiting the use of IRBs. The Revenue Expenditure and Control Act of 1968, discussed in greater detail in Chapter II, rescinded the tax-exempt status of IRBs but made certain important exceptions. Notable among these exceptions are so-called "small issues," the central focus of this study.

Depending on the project being financed, an IRB can fill any of a variety of purposes. With the exception of small issues, the purposes specified in the 1968 legislation suggest that, even though private firms were to be the primary beneficiaries of the subsidies, tax-exempt IRBs were intended mainly for quasi-public facilities, such as airports or wharves, or for quasi-public services, such as pollution control or solid waste disposal.[3] IRBs for these special purposes may be issued in any amount. In contrast, small issues, though they may be used for any purpose, are subject to maximum dollar limits.

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3. The 1968 act preceded federal pollution control legislation; thus, the subsidy was to offer an incentive for firms to invest voluntarily in pollution control equipment.

Under current law, no state or locality may float a small issue IRB for more than $10 million. Moreover, if in a given instance 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 following 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. If an IRB amounts to $1 million or less, though, the capital expenditure limit does not apply.

QUESTIONS RAISED BY THE GROWTH OF SMALL ISSUE IRBS

Sales of small issue IRBs have been growing more rapidly than IRB sales for any other purpose, with the exception of residential housing.[4] Between 1975 and 1979, annual small issue sales grew from approximately $1.3 billion to about $7.1 billion, and they reached an estimated $8.4 billion in 1980. In 1975, small issues accounted for approximately 4 percent of all long-term tax-exempt bond issues; in 1980, they represented 15 percent of the market. According to Congressional Budget Office estimates, if current law remains in effect, small issues could amount to between $15 billion and $49 billion by 1986, resulting in revenue losses increasing from approximately $1 billion in fiscal year 1981 to between $2.9 billion and $4.4 billion in fiscal year 1986.

The use of tax-exempt bonds to provide financing for private purposes has often been controversial and raises several fundamental issues. Under what circumstances should the federal government subsidize the borrowing costs of private industry? What public purposes or policy objectives do these interest subsidies serve? Are they intended to stimulate aggregate investment, to preserve or promote employment, to assist firms that otherwise could not profitably invest at conventional interest rates, or to correct imperfections in the market's allocation of capital? If interest subsidies serve any of these public policy objectives, are

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4. For further discussion of the use of IRBs for residential purposes, see CBO, Tax-Exempt Bonds for Single-Family Housing (April 1979).

tax-exempt bonds--which result in revenue losses that the federal government can neither supervise nor control--the best means of achieving these aims? Although these questions apply to most tax-exempt IRBs, in recent months, controversy has centered mainly on small issues.

Small issue IRBs in particular have drawn attention for several reasons. Sales are booming. All but three states (Hawaii, Idaho, and Washington) actively use tax-free financing. And, in recent years, small issues have financed a much wider variety of projects than has been the case in the past. Traditionally, IRBs were used to encourage investment in industrial facilities. Today, small issues are providing interest subsidies for every kind of enterprise from manufacturing plants to country clubs.

Although tax-exempt financing for industrial facilities continues, the less traditional uses of small issues have attracted increasing attention. In the summer of 1980, a development authority in Virginia Beach approved a $1.5 million bond issue for a private golf course.[5] A few months later, one of the largest retail furniture chains in the Washington, D.C. metropolitan area, benefited from a $5.8 million tax-free bond.[6] In a still more controversial case in Elmore County, Alabama, a national hamburger chain paid for the establishment of a local industrial development board to issue tax-exempt bonds for a fast food restaurant.[7] Across the country, local merchants and citizens groups in several towns have charged that the use of tax-free bonds to finance shopping centers and retail stores threatens downtown businesses and leads to unfair competition.[8]

While in some places the use of IRBs is drawing criticism, elsewhere it is proceeding with little controversy. Many state and

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5. Washington Post (September 17, 1980).

6. Washington Post (October 31, 1980).

7. Montgomery Advertiser (August 20, 1980); Wall Street Journal (October 8, 1980).

8. See, for example, Ravalli (Montana) Republic (June 27, 1980), The Dalles (Oregon) Chronicle (July 15, 1980), and the Alabama Journal (August 19, 1980), and the Washington Post (September 17, 1980).

local officials consider the bonds essential to stimulate new investment. In some cities, for example, tax-exempt bonds, together with federal UDAG funds, are helping to rebuild deteriorated commercial centers.

These trends have cast into sharp relief the questions concerning the public purpose of small issue IRBs. So far, federal legislation has left the definition of "public purpose" to state and local governments. Moreover, the law now covering the use of IRBs does not require state or local issuers to report IRB sales to any federal agency. Thus, both the purposes and the total annual volume of IRB financings have been extremely difficult to determine. The Congress may feel that this situation is satisfactory. On the other hand, since the subsidies that IRBs provide come primarily from federal revenues, the Congress may wish to examine more carefully the present trends in the uses and volume of small issues.

PURPOSE AND PLAN OF THE PAPER

The aim of this study is to provide the Congress with the information it needs to determine whether or not legislation governing small issue IRBs should remain the same or be changed and, if so, how. The chapters that follow cover the history, current volume, and extent of small issue IRB use; the growth potential of the small issues market; and the effects of small issue IRBs on investment, employment, and federal revenues.

Chapter II surveys the history and uses of IRBs from the 1930s to the present. It presents data, gathered primarily from state and local agencies, on small issue IRBs and it raises some of the questions that have been controversial in the past and that remain so today.

Chapter III describes the use of small issues in closer detail. It attempts to answer the following questions: What forces have led to the growth of small issue financing? How do states and localities define "public purpose"? What kinds of firms use the bonds and for what purposes? Does the use of small issues differ significantly among states or regions? Are the bonds an integral part of state and local economic planning? Do states and localities target small issues toward specific places or types of businesses? And how do small issues relate to other federal programs designed to stimulate economic development?

Chapter IV discusses the projected growth of small issues over the next five years; the effects of the bonds on federal, state, and local revenues and on the distribution of the federal tax burden; and the effects of small issues on investment, employment, firm location, and the behavior of financial institutions.

Chapter V presents a variety of alternatives for Congressional consideration. These range from removing all limits on small issue IRBs, on the one hand, to eliminating tax-exempt status on them, on the other. The options between these extremes vary from taking no action to changing current law in various ways, including imposing reporting requirements on the states that use IRBs, limiting tax exemption to small issues that carry the full faith and credit of the state or locality, imposing state-by-state limits on the volume of the bonds, and requiring that the bonds be targeted toward specific areas and types of businesses.

CHAPTER II. THE GROWTH OF SMALL ISSUE IRBS

In 1980, small issue IRB sales reached an estimated high of $8.4 billion. Small issues first appeared in the tax-exempt bond market following passage of the Revenue Expenditure and Control Act of 1968. Until then, IRBs could be used for any purpose and in any amount. Nevertheless, in 1968, the total sales of IRBs for all purposes combined were lower (in real terms) than are small issue sales alone today.

BEFORE 1960

The use of tax-exempt bonds to finance plant and equipment for private industry began in 1936, when the state of Mississippi passed legislation authorizing cities and towns to issue bonds to finance the construction of manufacturing facilities for lease to private companies. The purpose of the act was to aid a depressed agricultural economy by promoting industrial development. The first such bond, for $85,000, was issued to Realsilk Hosiery Mills in Durant. The issue floated for Realsilk had the backing of the state, and technically it was an IDB rather than an IRB. Two years later, when the law was challenged, the Mississippi Supreme Court upheld it.

Although the Mississippi legislation set a precedent, IRBs attracted little national attention for several decades. By 1950, only two other states, Alabama and Kentucky, had authorized their use. Gradually, however, IRBs began to spread, mostly to other southern states.

1960 TO 1968

By 1960, 17 states permitted the use of IRBs. For years, however, the annual volume of reported sales--which reached $100 million for the first time in 1960--had been low, and it remained so through the first half of the 1960s. But IRBs had already begun to cause concern. In 1963, the Advisory Commission on Intergovernmental Relations (ACIR) issued a report on IRBs, noting that they were "receiving nationwide attention bordering on notoriety," even though their annual sales volume was "quantitatively unimportant." The reasons the ACIR cited for its concern included "the pervasive fear that as the practice spreads, self-defense will drive local governments everywhere into participation." This, in turn, would "sap the fiscal strength of local governments . . . without contributing appreciably to the total volume of business activity" or "necessarily producing compensating public benefits."[1]

Again and again, IRBs have raised questions of whether, and if so, under what circumstances, financing private development serves a "public purpose." A uniform definition of public purpose has always been lacking. In its 1950 decision upholding IRBs, the Kentucky Court of Appeals avoided the issue altogether by declaring that, since revenue bonds had no effect on the debt of the issuing body, their public purpose was irrelevant.

The Kentucky decision, in turn, raised the question of whether IRBs were tax exempt under the provisions of the Internal Revenue Code.[2] If they had no effect on the credit of the issuing authority, did they qualify under the Tax Code as obligations of a state or local government? In 1954, and again in 1957, the U.S. Treasury Department decided that IRBs did qualify, and that interest on them was tax exempt.[3] These favorable rulings led to the passage of enabling legislation in several states, but reported sales remained low. Since IRBs were a little-known security, investment bankers were hesitant at first to underwrite them, and investors were reluctant to buy them. As more states began to authorize use of IRBs, they became better known and more attractive to large corporations, and by the mid-1960s, sales had taken off.

Between 1960 and 1968, the annual volume of reported IRB sales rose from $100 million to $1.8 billion, and the IRB share of the market for long-term tax-exempt municipal bonds rose from less

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1. Advisory Commission on Intergovernmental Relations, Industrial Development Bond Financing: A Commission Report (Washington, D.C., June 1963), p. 6-9.

2. Internal Revenue Code, Section 103.

3. Revenue Rulings 54-106, 1954-1 CB 28 and 57-187, 1957-1 CB 65.

than 1 percent to 9 percent.[4] This increase was attributable primarily to the rise in issue size, which grew from an average of $366,000 in 1957 to $7.8 million in 1967.[5] Within a short span, large corporations had come to recognize the usefulness of IRBs in financing expansion programs involving major capital expenditures. Between 1962 and 1967, for instance, nearly all the nation's newly built tire plants were financed with IRBs, as were several new paper and pulp mills, a shipbuilding complex, and an aluminum rolling mill slated to cost $250 million.[6] By 1968, the combined forces of competition and self-protection had led some 40 states to authorize the use of IRBs.

Critics of IRBs levied a number of charges against them: they used public funds to subsidize projects that could have gone forward with conventional financing; their proliferation undermined their original purpose of attracting industry to depressed areas; they resulted in revenue losses; and by raising the overall volume of tax-exempt bonds, they increased the costs of state and local borrowing for traditional purposes.

In March 1968, the U.S. Treasury responded to the surge in IRB issues by proposing new regulations to put an end to the tax-exempt treatment of IRBs. Most members of Congress agreed with the criticism of IRBs, and within a few months, the Congress passed the Revenue Expenditure and Control Act limiting IRB use.

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4. The reporting of sales is discussed in some detail later in this chapter.

5. 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. For a history of IRB use, see also Institute for International Law and Economic Development, The Industrial Revenue Bond as a Financial Attraction Device (September 1978).

6. According to the Wall Street Journal of December 4, 1967, virtually all of the major tire manufacturers used IRB financing between 1962 and 1967--Armstrong, Cooper, Dunlop, Firestone, Goodrich, Goodyear, Mansfield, Mohawk, and Uniroyal. See Arthur A. Thompson, Industrial Development Bond Financing: A Study by the Alabama Business Research Council (University of Alabama Press, 1970), p. 23.

THE REVENUE EXPENDITURE AND CONTROL ACT OF 1968 AND SUBSEQUENT IRB LEGISLATION

The 1968 act set forth the legislative structure that still governs IRBs.[7] It withdrew the tax exemption of IRBs for all but a few explicit purposes. The projects that retained the exemption include bonds to finance air and water pollution-control equipment; airports, docks, wharves, and related storage and training facilities; facilities for the local furnishing of electric energy, gas, and water; land acquisition and infrastructure development for industrial parks; mass transportation and parking facilities; residential housing; sewage and solid waste disposal facilities; sports facilities; and trade show and convention centers. The legislation also retained the tax exemption for bonds with a face value not exceeding $1 million to finance plant and equipment for other industrial facilities. The stated purpose of the small issue exemption was "to assist small businesses in locating in a community."[8]

A few months after the legislation passed, the Congress added another small issue exemption. This permitted state and local agencies to issue IRBs up to $5 million, with the stipulation that the total capital expenditures on the borrowing firm's facilities within a given city or county not exceed that amount for three years before the date of the issue or three years after. The capital expenditure limit, which was included in the Renegotiation Act of 1968, applied only to small issues of more than $1 million.

All of these changes in IRB legislation originated either as amendments offered on the Senate floor or in conference committee. The House versions of both the Revenue Expenditure and Control Act and the Renegotiation Act had contained no reference to IRBs. In the case of the capital expenditure limit, the Senate passed an amendment calling for a simple increase in the small issue ceiling from $1 million to $5 million. Supporters of the new measure argued that the $1 million limit was unrealistic and that providing an alternative to it would in no way undermine the

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7. Internal Revenue Code, Section 103(b).

8. Statement by Representative Wilbur D. Mills reviewing the history of the IRB legislation, Congressional Record--House (October 10, 1968), p. 30603.

goal of "stemming the flow of subsidies to very large companies."[9] In accepting an increase in the ceiling, the House conferees insisted on adding a capital expenditure limit to assure that the primary beneficiaries would be smaller companies.[10]

AFTER 1968

Aside from minor technical changes, the legislation governing IRBs was unaltered for 10 years. Then, in 1978, the Carter Administration proposed that the bond amount and capital expenditure limits for small issue IRBs be raised from $5 million to $10 million and that the bonds be restricted for use in financing projects in distressed areas only. The Congress responded by raising the issue and expenditure limits to $10 million for all projects, with the exception of those in distressed areas that receive UDAG funding. These were made subject to a capital expenditure limit of $20 million; however, the maximum issue amount for all projects was and still is set at $10 million, regardless of location. (The provision allowing $1 million in bonds to be issued without reference to capital expenditure limits was unchanged.) Advocates of the across-the-board increase in the limits from $5 to $10 million argued that, in 10 years, inflation had eroded the value of the original ceilings. The higher limits went into effect on January 1, 1979.

Although the volume of reported issues decreased sharply after 1968, the effects of the newly restrictive legislation were limited. The main impact was on large corporations that had used IRBs to finance major facilities, some costing more than $100 million. The $5 million capital expenditure limit put an end to

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9. Statement by Senator Carl Curtis, sponsor of the amendment to increase the IRB ceiling, Congressional Record--Senate (September 11, 1968), p. 26412.

10. For a history of the changes in IRB legislation, see Howard A. Zaritsky, "The Legislative History of the Income Tax Treatment of Industrial Development Bond Interest," unpublished paper, The Library of Congress, Congressional Research Service (August 12, 1977). See also debates and conference reports published in the Congressional Record for the following dates: Senate (March 26, 1968), pp. 7678-7702, and (September 11, 1968), pp. 26412-26419; House (June 20, 1968), p. 17987-17990, and (October 10, 1968), pp. 30600-30604.

such practices. But the legislation in no way curtailed IRB issues for small-scale projects. Nor did it curb the increase in the number of states authorizing the use of IRBs.

During the early 1970s, the volume of small issue sales appears to have been fairly low. The growth in IRB sales for other purposes resulted largely from the attractiveness of tax-exempt financing for pollution control. The Clean Air Act of 1970 and the Water Pollution Control Act of 1972 put pressure on firms to make capital expenditures to avoid contaminating the environment. Inevitably, investment bankers began promoting enabling legislation in each state to take advantage of the provisions of federal tax law. By the summer of 1972, the first vice-president of a major investment banking firm claimed, "We've been responsible for changing laws in fifteen to twenty states."[11] In many cases, the enabling legislation for pollution-control bonds also provided for the new or expanded use of small issue IRBs.

THE PRESENT IRB SITUATION (AND PROBLEMS IN ASSESSING IT)

Today, the annual volume of IRB issues in real terms far exceeds the levels reached in the 1960s. Furthermore, since most small issues are not reported, the growth in IRB use since 1968 has been significantly underestimated. Most IRB issues are privately placed with local banks, and records of them rarely exist beyond the state or local government level.

Although private placements were not uncommon before 1968, they might have increased as a result of a Securities and Exchange Commission (SEC) ruling that effectively discouraged the public sale of small issues. Before 1968, no obligations of state and local governments had to be registered with the SEC. The new ruling required that all IRBs of more than $300,000 be registered with the SEC unless they were general obligation bonds, they were privately placed with a limited number of investors who attested in writing that the bond purchase was for their own portfolios and not intended for resale, or the project was located in the state where the lessee was incorporated, and a public offering was limited to state residents who purchased only for investment and

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11. Quoted in Annmarie Hauck Walsh, The Public's Business: The Politics and Practices of Government Corporations (Cambridge, Massachusetts: The MIT Press, 1978), p. 151.

not for resale.[12] Since full SEC registration adds to paperwork and issuance costs, the net effect of the ruling was to encourage firms to seek private placements. In 1970, amendments to SEC regulations exempted virtually all IRBs from registration requirements. The practice of privately placing IRBs continued, however.

In general, the IRBs offered for public sale are used to finance the projects of large corporations, which have established relationships with securities underwriters. These sales are usually reported to the Daily Bond Buyer, the Public Securities Association (PSA), or both.[13] The bonds of smaller firms, on the other hand, tend to be privately placed, often without the involvement of investment banking or brokerage houses.[14] In most cases, the only public records of such transactions appears in the minutes of the meetings of local issuing agencies or in the records of county clerks.

Measuring the volume of IRBs has always been difficult because of the large number of issues placed privately. The smaller the bond issue, the more likely it is to be a direct placement. In all probability, most of the bonds issued before 1969 that exceeded $5 million were sold publicly and accounted for 80 to 90 percent of total sales. Once IRBs became subject to limits on the amount of the issue, not to mention on capital expenditures, direct placements grew. Today, measuring the volume of small issue sales with any precision is virtually impossible.

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12. SEC Rule 131 (17 CFR 230.131) under the Securities Act of 1933, and SEC Rule 36-5 (17 CFR 240.36.5) under the Securities Act of 1934. See also, Thompson, Industrial Development Bond Financing, p. 25.

13. The Daily Bond Buyer is a trade publication that concentrates on tax-exempt issues. The PSA is a professional association that represents securities dealers and publishes a monthly newsletter, Municipal Market Developments.

14. Privately placed bonds may or may not involve the services of investment banking or brokerage houses acting as agents for the borrower. Direct placements are also private, but the sole parties to them are the borrower, the lending institution, and the bond issuing authority.

CBO's Methods and Findings

To determine the extent of private (and particularly, direct) placements, CBO requested data from all of the states permitting small issues, and from selected local agencies. Although some

TABLE 1. COMPARISON OF DATA ON SMALL ISSUE INDUSTRIAL REVENUE BONDS, 1975-1979 (in Billions of Dollars)

	Congressional Budget Office[a]	Public Securities Association[b]	Daily Bond Buyer[b]
1975	1.3	0.5	0.5
1976	1.5	0.4	0.3
1977	2.3	0.8	0.5
1978	3.5	0.9	0.6
1979	7.1	1.7	1.3
1980	8.4	1.6	1.4

NOTE: For a few states, data include industrial parks, which occasionally have been financed with IRBs. The costs of these projects have generally been within the capital expenditure limits for small issues, and the number of projects has been small.

a. CBO's estimates are based primarily on information collected from state and local agencies. Where local data were incomplete or unavailable, data from the Public Securities Association were used. For a detailed state-by-state breakdown with notes on the sources of information, see Appendices A and B.

b. The Public Securities Association and the Daily Bond Buyer are the two main sources of data on tax-exempt issues of state and local governments. The data that federal agencies have traditionally used to estimate the volume of IRB issues have come from one or the other of these sources.

agencies had imperfect data and others could offer none at all, many had good records of both public and private bond sales during the last five years. These records indicated that between 1975 and 1979, the volume of small issue IRBs was four to five times larger than had previously been estimated.[15] The differences between CBO's and two other sources' estimates are contrasted in Table 1.

The CBO data represent an effort to include the market for direct placements in estimates of small issue IRB sales. Collecting accurate data, however, was a problem. The information from state and local agencies suggests that private placements account for 70 to 80 percent of small issue sales. For some states (such as Georgia), the only way to get accurate information would have been to correspond with each of more than a hundred local authorities. Some other states (such as Minnesota) publish annual reports listing IRB issues. Upon investigation, however, these turned out not to be actual closings but merely bond issues that the state had approved. For such cases, CBO checked with local and state authorities in an attempt to estimate actual sales. On balance, the likelihood is that CBO estimates understate the volume of issues because several states had incomplete reports. Although constraints on resources made it impossible to determine the precise volume of issues, CBO is confident that its estimates more closely reflect the realities of the market than do other estimates that primarily reflect public sales.

15. For a breakdown of the data and notes on sources of information on the specific states, see Appendixes A and B.

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CHAPTER III. THE USES OF SMALL ISSUE IRBS

In 1980, the dollar volume of small issue IRB sales was more than six times greater than it had been in 1975, reflecting the rapidly growing tendency to use the bonds for increasing numbers and types of projects. Four developments in particular account for the burgeoning popularity of small issues:

- The raised limits on permissible capital expenditures and on the size of bonds from $5 to $10 million initiated in 1979 had a dual effect. It made larger bond issues possible, and perhaps even more important, it loosened constraints on future investments, allowing many more firms to take advantage of the small issue exemption. Although only 6 percent of the total number of small issue financings in 1979 actually exceeded $5 million, they accounted for 23 percent of the total sales volume.

- The greatest increase in the use of small issues occurred in 1978 and 1979, when the savings in interest costs resulting from tax-exempt financing were relatively higher than at any other time in the 1970s. In general, IRB interest rates have conformed to the dominant trends in the bond market. Historically, tax-exempt interest rates have been roughly 30 percent below taxable rates. In late 1979 and early 1980, the difference widened to nearly 40 percent, but by mid-1981, it had narrowed considerably.[1]

- Even if small issues had not actually become increasingly attractive, soaring interest rates on conventional loans

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1. In 1975, the yields on new long-term municipal bonds with Moody's Aaa ratings were 72.7 percent of yields on similarly rated corporate bonds. In 1978, the percentage was 63.1, and in 1979 it dipped to 61. See John E. Petersen, "The Municipal Bond Market: Recent Changes and Future Prospects," unpublished paper delivered at the Conference on Financing State and Local Governments in the 1980s, Chicago (January 16-17, 1981), sponsored by the University of Illinois Cooperative Extension Division and others.

might have made them seem so. In 1975, the difference in interest rates was some 2 percentage points. During 1980, however, the difference ranged between 4 and 7 points.

- o Although past use of IRBs was largely for manufacturing, more and more states have issued bonds for commercial ventures, including office buildings, retail stores, and shopping centers. The current sales volume reflects this trend toward less traditional uses.

Small issue IRBs now finance a wide variety of ventures. Depending on the state, the issuing authority may be a state agency, a municipality or county, a local industrial development board, or some combination of these. Certain states circumscribe the use of IRBs, while others impose no restrictions beyond those stipulated in the Tax Code. Some states have programs for using IRBs to encourage smaller or riskier business ventures or to promote development in specific areas; others make no attempt to target them. In some areas, small issue IRBs are part of a package of economic development incentives; elsewhere, they are merely a source of cheaper credit.

USES

As the number of states using small issue IRBs has grown, so has the variety of activities benefiting from tax-exempt financing. Federal law in no way proscribes any particular uses. On their own initiative, some states have restricted the use of small issues to manufacturing and related storage facilities, but most have chosen to take maximum advantage of the latitude allowed under federal law. As of late 1980, nearly three dozen states permitted use of small issues for projects ranging from manufacturing to retailing. Among these 30-odd states, however, practices vary widely. In Massachusetts and New York, for example, the overwhelming number of projects are for manufacturing and related storage and distribution facilities. In Minnesota and Pennsylvania, commercial projects predominate.

Of the less conventional uses of small issue IRBs, five are becoming increasingly common:

- Commercial real estate development--including bank branches, corporation headquarters, general office buildings, office buildings and equipment for accountants, dentists, doctors and lawyers, and shopping centers.

- Retail stores--including automobile dealerships, department stores, fast food franchises, grocery stores, ice cream parlors, restaurants, and supermarkets.

- Recreational facilities--including bowling alleys, country clubs, golf courses, health clubs, private tennis and racquetball clubs, and skating rinks.

- Tourist facilities--including beach resorts, hotels and motels, and ski lodges.

- Health facilities--including proprietary (that is, for-profit) hospitals and nursing homes.[2]

PUBLIC PURPOSE

The diversity of small issue IRB uses reflects the extremely vague criteria in most states for determining whether or not a project confers a "public benefit." In general, IRBs meet state public purpose requirements if they finance projects that create or save jobs, or if they promote economic diversification. Before the mid-1960s, states in the South tended mostly to emphasize development of new industry. In the older industrialized states of the North and Midwest, where the use of IRBs had been uncommon, preserving jobs was stressed.

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2. The following states (or localities within them) supplied CBO with reports or lists of bond issues that included some (or all) of these uses: Alabama, Alaska, Colorado, Delaware, Georgia, Illinois, Indiana, Iowa, Kansas, Kentucky, Maine, Massachusetts, Michigan, Minnesota, Montana, New Jersey, New York, North Dakota, Ohio, Pennsylvania, South Dakota, Tennessee, Utah, Wisconsin, and Wyoming. Several other states permit some or all of these uses, but the information they submitted on small issues included only the name of the beneficiary firms, making the purpose of the project impossible to identify in most instances. Consequently, the data necessary to provide a national breakdown by purpose of the number and dollar volume of small issues are unavailable.

To cite a typical example, the Pennsylvania statute stipulates that local industrial development authorities shall operate for the purposes "of alleviating unemployment, maintaining employment at a high level . . . and developing business opportunities by the construction, improvement, rehabilitation, revitalization and financing of industrial, commercial, manufacturing, research and development enterprises."[3] These activities fulfill the public purpose of promoting the "health, safety, morals, and general welfare of the people." In Pennsylvania--as in many other states--any legitimate enterprise can benefit from IRB financing regardless of its location, the number of people it employs, or the firm's access to other sources of capital.

To assure that IRBs yield a net benefit to the state, some states prohibit their use for projects that require relocation within the state. A very few states have established more rigorous criteria. North Carolina is one. There, only industrial projects qualify, and only if each $7.5 million invested creates at least 100 jobs. North Carolina also requires that the average wage of the project financed with a small issue be above the average for the county or 10 percent above the average manufacturing wage in the state, and that the project have no adverse environmental impact.

Most states have at least some financial incentive to define "public purpose" rigorously, since the interest on IRBs is usually exempt from state income taxes. In a few states, IRB-financed projects are also exempt from property and sales taxes. These considerations appear to have had little effect on state laws, although property-tax exemptions, where they exist, have encouraged some cities and counties to be selective in their use of the bonds.

PATTERNS OF CORPORATE AND OTHER BUSINESS USE

The National Market

The beneficiaries of small issue IRBs range from multinational corporations to mom and pop grocery stores. In the 1960s, large corporations were the major users of IRBs. Since the early 1970s, most small issue IRB financing has consisted of direct placements,

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3. Commonwealth of Pennsylvania, Industrial and Commercial Development Authority Law, Report No. 11, pp. xi and 2.