Statement By

ALICE M. RIVLIN
DIRECTOR

CONGRESSIONAL BUDGET OFFICE

Before the

Committee on Ways and Means
U.S. House of Representatives

June 15, 1983

Mr. Chairman, the use of tax-exempt state and local bonds for private purposes has grown sharply over the past several years, and they now account for about half of all new long-term, tax-exempt issues. Last year, tax-exempt bonds for private purposes amounted to nearly $43 billion, up from about $28 billion in 1981 (see Table 1).

During the next five years, subsidies to private entities from tax-exempt bonds will cost the federal government an average of about $13 billion a year. That, for example, is as much as the federal government is expected to spend on highways. It is more than the $12 billion a year in estimated federal expenditures for assistance to public transit systems, wastewater treatment, water resources, airports, air traffic control and municipal water supply systems combined.

The growing use of tax-exempt bonds for private purposes and the resulting costs raise a number of questions. One issue is whether subsidies for private-purpose financing are still necessary, particularly in light of the business tax cuts enacted under the Economic Recovery Tax Act of 1981. A second is whether tax-exempt bonds are the most efficient means of providing subsidies, if any are necessary. A third is whether the municipal bond market can continue to absorb large increases in private-purpose financing. These issues are involved in the bills that the Committee is considering today.

My testimony this morning will deal with four matters:

- Recent trends in the use of tax-exempt bonds for private purposes;
- The likely effect of the bill to repeal the sunset date on mortgage revenue bonds for single-family homes;

TABLE 1. VOLUME OF LONG-TERM TAX-EXEMPT ISSUES BY TYPE OF ISSUE, 1975-1982
(In billions of dollars)

	1975	1976	1977	1978	1979	1980	1981	1982
Total Long-Term Tax-Exempt Issues	32.4	35.7	48.0	49.9	48.7	55.2	57.9	87.6
Total Private-Purpose Tax-Exempt Issues[a]	6.8	9.0	14.3	16.7	25.3	29.3	27.9	42.8
Housing bonds	1.5	2.7	4.5	7.1	12.1	14.0	5.6	14.4
Single-family MSBs	0.0	0.7	1.0	3.4	7.8	10.5	3.6	8.8
Multifamily IRBs	0.9	1.4	2.9	2.5	2.7	2.2	1.1	5.1
Veterans' GO bonds	0.6	0.6	0.6	1.2	1.6	1.3	0.9	0.5
Private hospital bonds	1.5	2.0	3.6	2.4	2.6	2.7	3.9	7.3
Student loan bonds	0.0	0.1	0.1	0.3	0.6	0.5	1.1	1.8
Pollution control IRBs	2.5	2.7	3.9	3.5	2.9	2.9	4.7	6.6
Small issue IRBs	1.3	1.5	2.2	3.4	7.1	9.2	12.6	12.7
Refunding Bonds	0.9	3.5	9.6	9.3	1.9	1.6	1.2	3.8
Other Long-Term Tax-Exempt Issues[b]	24.7	23.2	24.1	23.9	21.5	24.3	28.8	41.0

NOTE: MSB = mortgage subsidy bond; IRB = industrial revenue bond; GO bond = general obligation bond.

SOURCES: Data for housing bonds are from the Department of Housing and Urban Development, Office of Financial Management. Data for total pollution control, hospital, and other long-term tax-exempt bonds are from the Bond Buyer. (Private hospital bonds represent approximately 75 percent of all hospital bond issues.) Data on student loan bonds come from the Department of the Treasury, Office of Tax Analysis. Small issue IRB data are based on CBO surveys.

a. The total does not include private-purpose debt for airport and port facilities, industrial parks, sports facilities, trade show and convention centers, sewage and solid waste disposal facilities, mass commuting and hydroelectric generating facilities that could not be identified or classified.

b. Includes state and local government financing for public facilities and private purpose debt that could not be identified or classified.

- The likely effects of the bill to limit the use of industrial revenue bonds; and
- Some other alternatives that the Congress may wish to consider.

TRENDS IN THE USE OF TAX-EXEMPT BONDS FOR PRIVATE PURPOSES

Tax-exempt financing for private entities has been growing much more rapidly than tax-exempt financing for traditional public purposes. In 1975, tax-exempt bonds to provide low-cost financing to private entities represented only 20 percent of all new long-term issues. Since 1979, however, these bonds have accounted for about 50 percent of the market. As a percentage of GNP, tax-exempt bonds for private purposes more than tripled between 1975 and 1982 (see Figure 1). At the same time, bonds for public purposes declined as a share of GNP by more than 10 percent. In real dollars (adjusted for inflation), the volume of tax-exempt bonds for public projects in 1982 was about 5 percent higher than it had been in 1975, whereas tax-exempt financing for private entities was a whopping 300 percent higher (see Table 2).

Industrial revenue bonds (IRBs) are the primary mechanism for providing tax-exempt financing for private investment in plant and equipment. IRBs may be used without regard to issue size to finance pollution control equipment, private hospitals, airport and port facilities, sports facilities, convention centers, and industrial parks. Small issue IRBs, which may not exceed $10 million, may be used to finance plant and equipment for other unspecified private business purposes. Mortgage revenue bonds provide low-cost financing for both single-family and multifamily housing.

Small Issue IRBs. Small issue IRBs, which are used to finance a wide variety of facilities, account for the largest share of all tax-exempt bonds floated for private

Figure 1.

Tax-Exempt Bonds as a Percentage of GNP

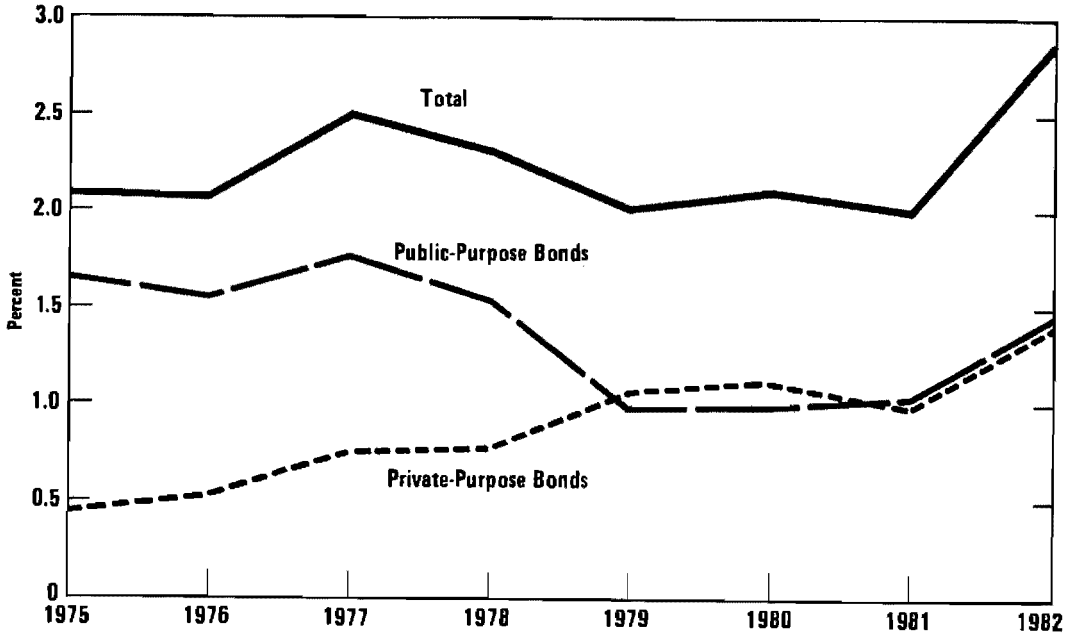

TABLE 2. VOLUME OF LONG-TERM TAX-EXEMPT ISSUES IN REAL DOLLARS, 1975-1982
(In billions of 1975 dollars)

	1975	1976	1977	1978	1979	1980	1981	1982
Total Long-Term Tax-Exempt Issues[a]	31.5	32.1	36.2	35.7	37.8	39.6	38.3	53.4
Private-Purpose Tax-Exempt Issues[b]	6.8	9.0	13.5	14.7	20.5	21.7	18.9	27.3
Other Long-Term Tax-Exempt Issues[c]	24.7	23.2	22.7	21.0	17.4	18.0	19.5	26.1

a. Excludes refunding issues.

b. The total does not include private-purpose debt for airport and port facilities, industrial parks, sports facilities, trade show and convention centers, sewage and solid waste disposal facilities, mass commuting and hydroelectric generating facilities that could not be identified or classified.

c. Includes state and local government financing for public facilities and private-purpose debt that could not be identified or classified.

purposes. All 50 states permit the use of small issues. Between 1975 and 1981, small issue sales increased from $1.3 billion to $12.6 billion. A preliminary CBO survey indicated that the volume of sales in 1982 increased only slightly to $12.7 billion; it is likely, however, that the final figure will be higher.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) imposed some restrictions on the use of small issue IRBs, but few state development officials contacted by CBO anticipated any major disruptions as a result.[1] CBO's analysis of the TEFRA restrictions was that they would have a minimal effect on the volume of small issues. Accordingly, economic recovery, especially if coupled with rising interest rates, will result in the continued growth in the use of small issue IRBs.

Pollution Control Bonds. Sales of tax-exempt pollution control bonds increased by 40 percent between 1981 and 1982, reaching $6.6 billion. These bonds finance approximately 40 percent of all private investment in pollution control equipment. Since the exemption for pollution control equipment antedated the passage of federal environmental control laws, it may initially have served as an incentive to induce firms to undertake pollution abatement measures voluntarily. Today, because federal regulations are so highly prescriptive, the availability of tax-exempt bonds has only limited influence on a company's decision to invest in pollution control equipment.

---

1. TEFRA requires IRB issuers to make quarterly reports to the Internal Revenue Service (IRS); requires an approval process involving either a public hearing and approval by an elected official or a public referendum; reduces, with certain exceptions, cost recovery deductions for IRB-financed property; eliminates the use of small issue IRBs to finance certain facilities, such as golf courses and racquetball clubs; and repeals the exemption for small issue IRBs after 1986.

Private Hospital Bonds. The volume of tax-exempt bonds used to finance private hospital construction increased a hefty 87 percent from $3.9 billion in 1981 to $7.3 billion in 1982. Tax-exempt bonds finance about half of all new hospital construction. The necessity of providing subsidies for new hospital construction has come into question because at present the United States has a surplus of hospital beds. Consequently, direct federal subsidies for hospital construction have been cut back sharply in recent years. Despite a national surplus, some areas might lack adequate hospital facilities, making selective use of some form of subsidy worthy of consideration.

Mortgage Revenue Bonds. State housing agencies began issuing tax-exempt bonds for single-family housing in the early 1970s, and local governments and housing agencies first issued them in 1978. Two years later, in response to a surge in these issues, the Congress passed the Mortgage Subsidy Bond Tax Act of 1980. This legislation sharply restricted the use of single-family housing bonds in order to reduce revenue losses and to target assistance more effectively. The act set limits on state bond volume and home purchase prices, introduced targeted area requirements, and restricted the subsidy principally to first-time homebuyers. It also contained a sunset provision that ends the use of bonds for single-family homes after 1983.

After rising sharply from $1.5 billion in 1975 to $14.0 billion in 1980, total housing bond volume dropped to $5.6 billion in 1981. The drop in volume resulted largely from the federal restrictions enacted in 1980 and the high interest rates prevailing during the year. As market conditions improved during the summer of 1982, many jurisdictions were able to issue bonds more easily. In 1982, tax-exempt bonds for housing finance totaled $14.4 billion--$8.8 billion for single-family housing, $5.1 billion for multifamily rental housing, and $0.5 billion for veterans' housing.

THE EFFECTS OF REPEALING THE SUNSET DATE FOR SINGLE-FAMILY MORTGAGE REVENUE BONDS

As the sunset date for single-family mortgage revenue bonds approaches, the Congress must choose whether to let this authority terminate, extend it in its current form, or extend it in some altered form. If current law remains in effect, the authority for single-family mortgage bonds will expire at the end of the year. At that time, $39.4 billion in bonds will still be outstanding. The revenue losses associated with these bonds will total $1.5 billion in 1983 and will rise to $1.7 billion in fiscal year 1984. Subsequently, the revenue loss will level off and begin to decline gradually. Total estimated revenue losses for fiscal years 1984 to 1988 amount to $7.9 billion.

If, on the other hand, the sunset date is repealed, revenue losses over the 1984-1988 period are estimated at $10.7 billion. The $2.8 billion difference understates the revenue effects of the continued use of the bonds, however. Every time a state or local government issues a tax-exempt bond, the federal government sustains revenue losses for as long as the debt is outstanding. Since most mortgage bonds have staggered or serial maturities of up to 30 years, a more appropriate way to look at costs is to calculate the amount of subsidy commitment over the life of the bonds.

To illustrate this point, although the additional revenue loss of not repealing mortgage revenue bonds would amount to an estimated $2.8 billion over the next five fiscal years, during the same period the federal government would commit itself to $24.1 billion in net new subsidies for single-family homes (see Table 3). Although mortgage revenue bonds involve a multiyear commitment, the long-term costs of new issues do not appear in budget documents. The full costs of most direct housing assistance programs do appear in the budget, however, with an amount of budget

authority expected to pay the full multiyear expense set aside at the time that new commitments are made.

TABLE 3. NET NEW SINGLE-FAMILY MORTGAGE BOND REVENUE LOSSES FROM REPEAL OF THE SUNSET PROVISION, 1984-1988 (In billions of dollars, by calendar year except as noted)

	1984	1985	1986	1987	1988	Total[a]
Estimated Bond Issues	10.4	13.0	16.9	20.4	23.6	84.3
Federal Subsidy Over the Term of the Bonds	3.5	4.2	5.0	5.4	5.9	24.1
Present Value of the Subsidy Commitment[b]	1.7	2.1	2.6	2.6	2.9	11.8
Fiscal Year Revenue Losses	0.1	0.2	0.5	0.8	1.2	2.8

a. Totals may not add because of rounding.
b. The present value is the multiyear stream of revenue losses discounted for the fact that losses in the later years have a lower current cost than those in the early years.

THE EFFECTS OF PENDING LEGISLATION TO REDUCE THE USE OF IRBs

Legislation now before the Committee (H.R. 1635) proposes that assets financed with tax-exempt bonds be depreciated using the straight-line method over recovery periods that are longer than those now permitted under the Accelerated Cost Recovery System (ACRS).[2] In addition, small issue IRBs would not be allowed for businesses with

2. The proposed depreciation recovery periods are 5 years for equipment in the 3-year class; 8 years for equipment in the 5-year class; 15 years for equipment in the 10-year class; 22 years for 15-year public utility property; and 25 years for 15-year real property, with the exception of low-income housing, which would remain eligible for ACRS deductions.

capital expenditures nationwide of more than $20 million during the three-year period before the bonds are issued, or with more than $20 million of outstanding small issues. Finally, the use of small issue IRBs for land acquision would be prohibited.

These proposals would reduce the volume of pollution control bonds and small issue IRBs. The effect on pollution control bonds would be small--probably no more than 10 percent. The reason is that the depreciation recovery periods allowed under the bill are still short enough so that IRBs coupled with straight-line depreciation would result in greater tax savings than ACRS and conventional financing for every asset class, with the exception of 15-year real property (see Table 4). In general, the choice between ACRS and IRBs will depend largely on a firm's ability to use depreciation deductions fully. In theory, the bill should have no effect on the use of pollution control bonds by firms that have sufficient income to use depreciation deductions. In practice, it would reduce the use of these bonds slightly because firms sometimes make decisions based on the amount of tax writeoffs during the early years of a project, rather than on total tax savings over the life of the project.

The bill would have a much greater effect on the use of small issue IRBs because these bonds frequently provide financing for real property and land. Moreover, the proposed limit on capital expenditures will make it impossible for most Fortune-listed firms--and some smaller ones--to use the bonds. The CBO estimates that the effect of these measures would be to reduce the volume of small issue IRBs by about 40 percent.

Although the bill would have little effect on pollution control financing and none on private hospital or student loan bonds, it would result in immediate revenue gains.

TABLE 4. PRESENT VALUE OF AFTER-TAX SAVINGS FROM ALTERNATIVE METHODS OF FINANCING AND DEPRECIATING A $10 MILLION INVESTMENT IN EQUIPMENT OR REAL PROPERTY[a] (In thousands of dollars)

Tax Provision	3-Year Equipment[b]	5-year Equipment[c]	10-Year Equipment[d]	15-Year Public Utility Property[d]	15-Year Real Property[e]
Expensing	4,600	4,600	4,600	4,600	4,600
ACRS, ITC and Conventional Financing	4,097	3,875	3,310	2,860	3,070
Current Law Alternative (Straight-Line Depreciation Over ACRS Recovery Period)	4,775	4,752	4,359	4,035	3,715
H.R. 1635 Alternative (Straight-Line Depreciation Over 5- to 25-Year Recovery Periods)	4,439	4,353	3,888	3,563	3,051
Administration's 1982 Proposal (Straight-Line Depreciation Over 5- to 35-Year Recovery Periods)	4,439	3,920	3,259	3,022	2,649

a. Assumes a 3 percentage point differential between tax-exempt and taxable interest rates and a 46 percent corporate tax rate. The terms of the bonds vary, as indicated, with the type of property being financed. Tax savings are stated in present value terms, using a 10 percent discount rate. Present value discounting is a procedure used to assign a value to funds that will be received at specific future dates. It is designed to take into account the fact that the promise of funds in the future is less valuable than having the money presently in hand.

b. Assumes a 7-year bond term.

c. Assumes a 10-year bond term.

d. Assumes a 15-year bond term.

e. Assumes a 20-year bond term. The ITC is inapplicable. Low-income housing is excluded.

These revenue gains will rise from $100 million in fiscal year 1984 to approximately $1.4 billion in fiscal year 1988.

POLICY ISSUES AND ALTERNATIVES

Both of the bills now pending before the Committee raise the same policy issues: Are the subsidies necessary? Are they efficient? And what effect do they have on the municipal bond market?

The Need for Subsidies. At present, firms that avail themselves of tax-exempt financing can take straight-line depreciation over the ACRS recovery periods. Unless the Congress has a special reason for providing industry with subsidies so deep that they result in a negative tax rate, the idea of trading shorter depreciation recovery periods for tax-exempt financing would appear to be equitable. Currently, the combination of IRB financing and ACRS recovery periods for three-year and five-year equipment results in greater tax savings than would occur if the investment were immediately recovered in full (or "expensed"). This can cause distortion in capital resource allocation.

Regarding single-family housing bonds, the issues have more to do with the effectiveness of current programs and the desire of the Congress to provide housing subsidies. The experience under the targeting provisions of the Mortgage Subsidy Bond Act has been mixed. Some housing agencies and local governments have targeted their programs as much as possible on economically distressed areas and low-income homebuyers, whereas others have sought to minimize the impact of the targeting provisions in order to improve the financial backing for the bonds and to reassure

bondholders. Roughly half of the recipients of loans appear to be low- to moderate-income households--that is, with incomes at or below the median for their areas. The Congress has to determine whether to continue subsidies, and if so, whether to do so under the current program.

The Efficiency of Tax-Exempt Bond Subsidies. If subsidies are necessary, it is questionable whether tax-exempt bonds are the best way to provide them. Direct subsidies are usually a less expensive and more efficient alternative. A CBO analysis undertaken a few years ago indicated that, in the case of tax-exempt mortgage bonds, approximately 54 percent of the subsidy went to the homebuyers. Most of the remainder went to bondholders and, to a lesser extent, intermediaries, including issuers, underwriters, and bond counsel.

Tax-exempt bonds often result in other inefficiencies. In the case of pollution control bonds, for example, tax-exempt financing is available only for "end-of-pipe" capital expenditures, which discourages selection of other, possibly more effective, solutions to the underlying problem--such as the use of less polluting raw materials or production processes. In the case of hospitals, targeting direct subsidies to areas with shortages of adequate facilities may be a much less costly and more efficient means of providing assistance than the continued universal availability of tax-exempt financing.

The Effects of the Municipal Bond Market. Although municipal bond rates declined steadily throughout most of 1982, the relative advantage of tax-exempt financing diminished. Tax-exempt rates, which historically have tended to be approximately 30 percent lower than conventional rates, are now only 20 percent lower. The growth in private-purpose financing is partially responsible for the erosion in the

savings normally associated with tax-exempt bonds. The reduction in the maximum tax from 70 to 50 percent and the expansion of other tax-favored investment options in the 1981 Tax Act have lessened individual and institutional demand for tax-exempt bonds. Despite these structural changes, cutbacks in the volume of tax-exempt bonds for private purposes can only reduce the cost of financing public projects.

Policy Alternatives. The alternatives before the Congress are to maintain current law, to repeal the sunset date on mortgage revenue bonds, or to continue housing and industrial revenue bond subsidies in some altered form. If the use of mortgage bonds is continued, the Congress could target the subsidy more narrowly on low- and moderate-income households by placing federal income limits on homebuyers or by limiting the subsidy to homebuyers who forgo the deduction of mortgage interest from taxable income. Although income limits would concentrate the subsidy on those homebuyers most in need of financial aid, they probably would not reduce the volume of mortgage bonds significantly unless they were very low. Income ceilings would also involve administrative problems of monitoring compliance and making adjustments for regional cost-of-living variations. Limiting the subsidy to homebuyers who forgo the deduction of mortgage interest could have a greater effect on volume. It would also be an administratively simpler way to target assistance to lower-income households. Taxpayers in higher marginal brackets would be better off taking the interest deduction and would automatically exclude themselves from the program. Lower-income homeowners benefit little or not at all from mortgage interest deductions and so would prefer the subsidy.

Whether or not the Congresss repeals the sunset provision in the Mortgage Subsidy Bond Tax Act of 1980, further restrictions on the uses of tax-exempt bonds for

private purposes may be in order. These restrictions may take the form outlined in the bill now before the Committee; however, if the depreciation recovery periods were longer than those proposed in the bill, the volume of IRBs could be reduced more substantially. Last year, the administration proposed recovery periods ranging from 5 to 35 years.

The Congress may also wish to consider subjecting IRBs to state-by-state volume limits. At present, only mortgage bonds are subject to such limits. For the sake of simplicity, the limits would probably best be based on population. One alternative would be to set state-by-state limits for all private-purpose bonds, which would permit the states to decide for themselves how to allocate subsidies among housing, health care, and private industrial and commercial facilities. Limits could be set at the current national volume, or lower, or they could be gradually reduced. If limits were set to result in a $10 billion a year reduction in bond issues beginning in 1984, the revenue gains in fiscal years 1984 - 1988 would amount to about $2 billion. These savings could be used to reduce the deficit. Alternatively, they could be used to provide additional federal assistance to help states and localities meet their infrastructure needs, which under current policies will require nonfederal outlays averaging $25 billion a year.

In conclusion, Mr. Chairman, tax-exempt financing for private purposes has been an issue for several years. The legislation before the Committee seems to be trying to address the question of whether the current federal subsidies continue to be necessary. Clearly, the question needs to be addressed.