The Tax Exemption of Interest
on Industrial Development Bonds

An industrial development bond is a debt obligation issued under the name of a State or local government for the benefit of a private industrial corporation. The typical case involves a municipality which issues bonds to finance the building of a factory for a private corporation which in turn pays "rent" for the factory set at the precise amount needed to pay the interest and amortize the principal of the bonds.* Characteristically the bonds are revenue bonds payable only out of the rent and the municipality assumes no obligation, direct or indirect, for their payment. Thus, such bonds really represent bonds of a private corporation, but because the municipality places its name on the bonds, it claims and passes on to the private corporation the full benefit of the lower interest rate attributable to the Federal tax exemption of interest on state and municipal bonds.

In most instances the industrial development bonds are secured only by the earnings of the private corporation and bond buyers generally look only to the credit rating of the lessee corporation in assessing the merits of the bonds as an investment. In frank recognition of the economic reality of the transaction state courts generally agree that industrial development revenue bonds are not debts of the issuing government unit for purposes of applying the debt ceiling or similar state law restrictions on municipal financing. In some less prevalent situations general obligation bonds secured by the lease revenues are used, so that the municipality assumes a subordinate role as guarantor of the corporate obligation. However, the lease revenues are regarded as the principal security behind the bonds and the use of general obligation bonds does not materially alter the abuses that flow from the transaction.

In all cases the exemption of interest on industrial development bonds from Federal income tax is simply a Federal subsidy to private corporations. The lower interest rates--which are passed on to the private corporations in the form of lower rental charges--are only possible because of the tax exempt status of the interest in the hands of the bondholders. Therefore, the full benefit derived by private industry is achieved only at the expense of a loss of Federal tax revenues. Moreover, it is a forced Federal subsidy. The amount of the subsidy, the beneficiary of the subsidy, or the use to which the borrowed funds are put are not considered in any way by the Federal Government. The sole decision as to whether or not to benefit a private corporation rests with the various State and local governments and, since industrial revenue financing imposes no direct costs on the issuing governmental units, there is no agency that has any effective interest in assessing the merits of extending Federal tax benefits to any particular private corporate beneficiary.

In addition industrial development financing represents a most inefficient and uneconomic means of subsidizing private industry. The cost to the Federal Government in lost tax revenues substantially exceeds the financial benefits that corporations realize through their

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* In some situations the transaction takes the form of a deferred payment sale of the property to the industrial user. The payments made on the note and mortgage securing the sale proceeds are used to make the payments on the bonds.

ability to borrow funds at lower interest rates. As the attached table illustrates it would not be unusual for a transaction involving a highly rated corporation to annually cost the Federal Government almost three times as much in lost tax revenues as the benefit the corporation gets from the transaction. Moreover, the cost to the Federal Government will constantly increase as the volume of tax exempt bonds grows larger and interest rates for all tax exempt obligations rise in order to elicit more demand, particularly from relatively lower bracket taxpayers.

From the standpoint of the State and local governments, the industrial development financing technique was originally developed as a means of attracting industry to low income and labor surplus communities. Before 1961 these bonds were primarily used to finance small manufacturing firms locating in rural areas. Recently, however, multimillion dollar revenue bond issues have financed a number of industrial projects for some of our major industrial concerns. Moreover, as the attached table indicates, the growth of this financing device has tended to parallel the shift in the use of such bonds. Thus, in 1960 when only 13 States authorized industrial development bonds, the total of new issues sold to the public in that year amounted to only $70 million. By the end of 1966 the number of States authorizing such bonds had increased to 35 and publicly issued new bonds in that year involved over $500 million. Indicative of the trend towards use of such bonds by our largest corporations is the fact that the eight largest issues in 1966 accounted for $344 million, over 60 percent of the estimated $500 million in new public issues for that year. Finally, it should be noted that this geometric growth rate is continuing. Over 40 states authorize industrial development bonds today and although final data is not available for 1967, preliminary tabulations indicate that well over $1 billion industrial development bonds were publicly marketed last year.

Figures are generally available only for bonds marketed to the public. In many cases the issues are privately placed with banks, other lenders or the company itself. No reliable data are available as to the amount of privately placed issues but they may involve more than twice the amount of publicly sold issues.

Although this practice is defended as a means of attracting new industry, many have questioned whether the availability of industrial development financing was ever a significant incentive to locate in a particular area. They point out that a commitment to move a substantial enterprise into a totally new locality for a long period of time is such a serious decision that the benefit of low cost financing is a rather minor factor when compared to such economic considerations as the corporation's access to raw materials or to its existing and potential markets. However, to whatever extent the use of industrial development bonds has been a significant factor leading to the dispersion of industry in the past, it seems clear that in present circumstances, with an ever increasing number of states authorizing such bonds, the utility of industrial development financing as an incentive to attract industry is rapidly disappearing. Since the issuance of industrial development revenue bonds involves neither risk nor direct cost to the issuing locality, there is little reason for any locality to deny a corporate request. Thus, even assuming that such funds are an important factor influencing the selection of a relocation or expansion site, a private corporation embarking on an expansion program today has over 40 states to choose from. This total is actually larger because even in states which do not authorize such issues, political subdivisions may be engaged in this practice. Once all fifty states are forced by competitive considerations to authorize industrial development financing the ability to attract industry through the use of such bonds will be totally nonexistent. Thus, the continued proliferation of such bonds will merely increase the Federal revenue loss without any appreciable economic benefit to the Nation or the State and local governments.

Moreover, not only is the basic objective of industrial development financing to attract industry essentially self-defeating, but the rapid growth in the dollar volume of such bonds works to the positive detriment of all State and local governments. The benefits State and local governments receive because of the Federal tax exemption of the interest on their bonds is dependent on the fact that tax-exempt bonds are a unique exception and that most bonds -- both corporate and Federal -- are fully subject to Federal income tax. As more industrial development bonds are issued the interest rate on all tax-exempt bonds must increase in order to make the total supply of exempt bonds attractive to lower bracket taxpayers.[*] Moreover, in recent years some of the largest industrial corporations in the Nation have used industrial development bonds and many of our smaller State and local governments find themselves severely handicapped when they are forced to compete for funds in the same limited market against these corporations. (See, e.g., statement of Senator Ribicoff, Vol. 113 Cong. Rec. pp. S 16022-16023, November 8, 1967. See also the attached table of large (over $10 million) industrial development bond issues in 1967.

It has been estimated that in recent years the increase in normal State and local government bonds outstanding has been growing at the rate of $6.5 billion annually. In 1967 over $1 billion of industrial development bonds were added to the demand for new funds with the obvious result that the interest rates that State and local governments had to pay on bonds issued to finance governmental functions were higher than they need be. For example, the Finance Administrator of New York City in testimony before the Joint Economic Committee on December 5, 1967, estimated that the existence of industrial development bonds increased New York City's borrowing rate by 3/8 of one percent and increased the city's debt service cost by almost $2 million last year. This type of market effect was not confined to one city, it affected

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[*] If there were only a few tax-exempt bonds in existence they would be purchased by the few high rate taxpayers who would benefit most by the tax exemption. There are an appreciable number of individual taxpayers facing a marginal rate of 70 percent. Thus, if we had only a few tax-exempt bonds, the competition between buyers would drive interest rates on these bonds down sharply, probably to a level close to 70 percent below rates on comparable quality taxable issues. But in fact there are over $100 billion of tax-exempt bonds in the market, and the issuers have therefore had to turn to buyers with much lower marginal tax rates than 70 percent. The marginal buyer in a lower tax bracket thus determines the market differential between comparable quality taxable and tax-exempt bonds. Tax-exempt bonds carry, therefore, a much lower discount compared to taxable bonds than would occur if there were only a few exempt bonds. Recent estimates of this discount or differential indicate that it is approximately 30 percent. Thus, the addition of a significant volume of industrial development bonds in this limited market necessarily decreases the discount which all tax exempts carry and thus increases borrowing costs for traditional State and local functions. As indicated later in the text, the effect on the discount becomes even clearer when the flow of industrial development bonds is compared to the amount of traditional state and local bonds annually issued.

all State and local governments that borrowed funds last year. This, of course, means increased property taxes, sales taxes and state income taxes. Thus, it is clear that industrial development bonds, while imposing no direct costs on the issuing governmental unit, are not cost free to State and local governments. In fact they are very expensive and their cost is mounting dramatically each year -- a cost which must be borne by all State and local governments not just those that issue the bonds.

In sum it seems evident that the use of industrial development bonds is ceasing to have any meaning as a device to attract industry to a given State or locality. Instead, these bonds are rapidly becoming a self-defeating device that will inevitably work against the long range best interests of all States. However, even when all States authorize industrial financing and it thereby becomes a completely meaningless attraction for industry -- completely meaningless because any corporation knows that wherever it decides to locate it can ask for and receive the benefit of tax exempt borrowing -- it is unlikely that we will see a decline in industrial development issues. The reason is simply that since such financing imposes no direct cost on a municipality, no single municipality can afford to withhold its approval of any issue even though the participation of all municipalities works to the very real detriment of municipalities generally. The question will not be one of attracting industry but rather one of losing an industry for failure to issue the bond -- an industrial corporation will simply say it will not even consider a particular locality unless the local government assures the use of industrial development bond financing. Therefore, it seems clear that if this abuse is to be curtailed the impetus will have to come from the Federal Government. Moreover, in view of the recent growth of such financing and the significant cost of the Federal subsidy involved, it would seem appropriate to correct the situation as soon as possible.