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STATEMENT OF THE HONORABLE JOHN E. CHAPOTON  
ASSISTANT SECRETARY (TAX POLICY)  
BEFORE THE  
SUBCOMMITTEE ON OVERSIGHT  
COMMITTEE ON WAYS AND MEANS

Mr. Chairman and members of the Subcommittee:

I am pleased to appear before you today to present the views of the Treasury Department on the current use of exempt "small issue" industrial revenue bonds. At the outset, I must stress that the Treasury Department's principal focus at this time is on the economic program of the President and the tax proposals which are a part of that program. Our comments on the current uses of exempt small issues, the effect that the issuance of such obligations may have on Federal revenues, and any recommendations that we may offer must be understood as secondary to the overriding need for swift action on the President's program. As you know, we have requested that Congressional action with respect to tax measures other than this program be deferred until the completion of legislative action on the President's economic program.

I. Background and current law.

An industrial development bond is an obligation issued by a state or local government, or a duly constituted authority acting on its behalf, for the benefit of a private borrower. In the typical case, a local authority will issue obligations to finance the acquisition of a building or equipment which will, in turn, be leased to a private person. The amount paid by the private user under the "lease" is set at an amount which will amortize both the principal and interest on the obligations. For tax purposes, however, the private person is generally considered the owner of the property and entitled to depreciation and any available tax credits.

In most cases, these obligations are payable only out of the revenues derived from the facility -- the issuing jurisdiction assumes no obligation, direct or indirect, for their repayment. In some more limited cases, the obligations will be general obligation bonds secured by the revenues under the lease, the state or local government assuming a subordinate position as guarantor. Because bonds issued under either of these alternatives are nominally obligations of the state or local government, however, the interest is exempt from Federal tax. It should be noted that state courts generally do not regard these revenue bonds as obligations of the local governmental unit and purchasers of such obligations look to the credit rating of the underlying private user, not the issuer, in evaluating the obligations. Moreover, issuance of these obligations generally imposes no additional cost on the state or local government.

The technique of using industrial revenue bonds to finance facilities for private persons originated as a means of attracting industry to low income and labor surplus communities. Prior to 1961, only 17 states authorized such bonds and their use was generally restricted to providing financing for small industrial concerns in rural areas. By 1968, however, conditions had changed and many states and localities had begun to use this financing tool. As a result, its influence on firms' locational decisions was significantly reduced. Moreover, the increased volume of new issues had affected the interest cost of traditional public borrowings to such a degree, and had raised fears of an ever expanding loss of Federal revenues as greater amounts of long term private borrowing were financed at tax exempt rates, that Congress enacted specific statutory provisions to curb the issuance of such obligations.

The Revenue Expenditure and Control Act of 1968 (Pub. L. 90-364) introduced the basic provisions that now govern the taxability of interest on industrial revenue bonds. The Act permitted the issuance of tax exempt industrial revenue bonds if the proceeds were used to provide so-called "exempt facilities" (docks, sports facilities, pollution control facilities, and similar quasi-public facilities). No dollar limitation was placed on the amount of such bonds, provided that substantially all (i.e., 90 percent) of the proceeds were used to provide the exempt facility.

Another provision in the 1968 legislation permitted the issuance of tax exempt "small issues," where substantially all of the proceeds were used for the acquisition of land or the acquisition or construction of depreciable property (neither working capital nor inventory is eligible to be financed by an exempt small issue). The stated purpose of this provision was to assist small businesses. There were no statutory limitations placed on the type of activities which such issues could finance, although it can reasonably be inferred that the

draftsmen of the legislation had industrial and manufacturing facilities in mind. There were ceiling amounts for each exempt small issue, however.

With some modifications and additions, this statutory framework now governs the taxation of interest on industrial revenue bonds in general, and exempt small issues in particular.

The exemption for small issues has attracted particular attention recently. Under current law, there are two categories of exempt small issues, those subject to a \$1 million cap and those subject to a \$10 million cap. Under the first ceiling, obligations may be issued up to an aggregate face amount of \$1 million if substantially all the proceeds are used for land or depreciable property, or to redeem part or all of a prior exempt small issue. In computing the \$1 million ceiling, the amount of certain prior exempt small issues is required to be aggregated with the issue in question. Subject to applicable state or local law, there is no limit on the overall size of the facility that is eligible to be financed with this category of exempt small issues. Thus, if local law does not pose an impediment, a private corporation can construct a \$100 million facility in County X, and, provided that it has no other bond financed facilities in that county, County X may issue up to \$1 million in tax exempt industrial revenue bonds to finance part of the cost of the private corporation's facility.

The second category of exempt small issues--those issued under the \$10 million ceiling--is available only if the issuer makes a special election and the issue is subject to further limitations. As in the case of bonds issued under the \$1 million ceiling, certain prior exempt small issues must be aggregated with the current issue in calculating the issue size. In addition, certain capital expenditures made for facilities located in the political jurisdiction where the bond financed facility is located must be aggregated with the current issue to determine if the \$10 million cap has been exceeded. For example, if a private corporation proposes to construct a \$7 million plant with financing to be provided by an exempt small issue, and that same person, or a related person, has constructed a \$2.5 million office building in the same political jurisdiction within the previous year, the amount of the corporation's capital expenditures with respect to the office building must be aggregated with the later exempt small issue for purposes of determining whether the \$10 million ceiling amount has been exceeded. In computing these capital expenditures, a special rule is provided for facilities that are furnished in connection with a grant under section 119 of the Housing and Community Development Act of 1974 (a "UDAG" grant). In that case, capital expenditures not to exceed \$10 million may be excluded in computing the \$10 million ceiling, thereby effectively increasing the size of projects that can be financed.

Under the provisions relating to small issues in the Internal Revenue Code, there is no Federal requirement that the bond financed facility serve a public purpose, or even quasi-public purpose. Moreover, their issuance generally does not impose any incremental cost on the issuing jurisdiction. The lower interest charges to the business owner of the facility are financed out of Federal tax revenues. The only restrictions which govern the use of exempt small issues are those applicable under state or local law. Some states restrict the issuance of exempt small issues by limiting their use to certain specified types of activities (e.g., industrial plants). Other states, however, impose virtually no restrictions on their issuance so that they can freely substitute for conventional debt. Further, many states have no centralized clearinghouse for these issues and thus they are unaware of the actual volume of such issues within the state.

## II. Allegations of abuse in the small issue area.

The current controversy over exempt small issues appears to be dominated by a number of issues, among which are the following:

- o the rapid expansion in the volume of exempt small issues and the effect that this may have on interest costs for traditional public borrowing
- o the fear of increasing Federal revenue losses as this method of financing for private long-term debt expands
- o the resource misallocation caused by the availability of below market interest rates through the use of exempt small issues
- o the prevalence of their use for commercial as opposed to industrial projects
- o the lack of review over the issuance of these obligations and the lack of a nexus between the project and the issuing jurisdiction or authority.

In recent years, the volume of tax exempt bonds issued for nongovernmental purposes -- private residences, pollution control facilities, exempt small issues, etc. -- has increased sharply. These obligations have begun to occupy an increasing share of the market for tax exempt securities. The expansion in the volume of exempt small issues has been quite significant, as the data assembled by the Congressional Budget Office illustrates. Between 1978 and 1979, the annual dollar volume of new small issues more than doubled -- growing from \$3.5 billion to \$7.1 billion. The volume of these obligations has continued to grow, reaching an estimated \$8.4 billion in 1980 -- an annual rate of expansion of approximately 18 percent between 1979 and 1980. Moreover, it is reasonable to expect that the growth in the volume of exempt small issues is likely to continue at its

current pace. Future growth may be encouraged by: the prospect of continued high interest rates; an increase in the number of firms making use of exempt small issues; the opportunity for issuing authorities to earn fees; and competition among localities to provide similar services.

The increase in the volume of exempt small issues may be damaging to the market for tax exempt securities as a whole. It effectively raises the borrowing costs for traditional public projects such as schools and municipal improvements. As the supply of tax exempt securities expands, the relative return on such securities must increase in order to attract additional capital into this market. This may lead to an increase in the tax exempt interest rate, which would be reflected in higher taxes or user charges for state and local governmental facilities.

There is also a concern that the greater volume of tax exempt industrial revenue bonds will lead to a growing loss of Federal revenues. The Congressional Budget Office estimates that the annual revenue loss attributable to exempt small issues will rise to approximately \$1 billion by 1981. At a time when the budgetary impact of Federal programs is being reviewed, the impact of this program on Federal revenues needs to be examined carefully.

Critics of industrial revenue bonds also argue that the ability of some businesses to reduce their costs of borrowing through the use of exempt small issues, while similarly situated businesses must pay a market rate of interest, leads to a misallocation of resources and raises questions of fairness. If left to the market, they argue, financing decisions are generally based on the relative economic return of the projects, i.e., the more productive project is able to bid a higher price for the available supply of credit. With the interposition of a local industrial or commercial development authority, however, the allocation of credit is likely to be based on other, noneconomic factors.

In response to this criticism and the estimates of the Federal revenue loss, others would argue that small issue industrial revenue bonds provide some positive contribution at the margin. They view exempt small issues as reducing the cost of capital to the firms using industrial revenue bonds and increasing the after-tax rate of return to bond holders, thereby resulting in a net increase in capital formation. The total volume of financing outlays is, they claim, greater than otherwise. They argue that some exempt small issues must be treated as net additions to the total amount of outstanding financial claims.

In addition to the rapid expansion in the volume of exempt small issues, these obligations have been used increasingly for commercial, as opposed to industrial or manufacturing, projects.



Critics point to their growing use for shopping centers, fast food franchises and large retail operations. As pointed out earlier, any limitations on the use of the proceeds of exempt small issues are a matter of state or local law -- no activity restrictions are incorporated in the Internal Revenue Code. The use of exempt small issues to finance these types of projects must be reviewed carefully to determine whether the pattern of their use is consistent with the other aspects of the President's program designed to increase our nation's productivity and our other economic goals.

Finally, exempt small issues have been criticized because the standard to be met for showing a public purpose for the lending of the state or local government's tax exemption is, in many cases, vague. Moreover, in some instances, the nexus between the issuer and the facility to be financed was, at best, tenuous. Critics point to the large number of exempt small issues used to finance professional offices, racquetball courts, and other types of facilities which, they argue, fail to serve any legitimate policy goals. These practices of issuing authorities need to be reviewed. In addition, critics point to exempt small issues being used to finance facilities far outside of the issuing jurisdiction's geographical area. To the extent that the purpose of the exempt small issue provisions is to permit local authorities to foster a local public purpose, such practices appear inconsistent with that goal.

### III. Conclusion

At this time, the Treasury Department's review of the small issue area has not been completed. As I stated at the outset, our principal focus has been on the President's economic program. That program contains a well balanced mix of proposals designed to encourage savings and capital formation. We are continuing to review the exempt small issue provisions, both from the perspective of the criticisms reviewed above and from the standpoint of their relationship to the goals of the President's economic program.

During our review, we will focus careful attention upon the estimates of the volume of these loans and their effect on Federal revenues. We will also assess carefully the allegations of overreaching by local authorities and the extent to which there may be technical defects in the operation of these rules. Among the possible modifications to current law that deserve consideration are proposals which would require closer scrutiny by state and local governments of the volume of industrial

revenue bonds for projects within their jurisdictions. These might include a requirement that the state or local government provide a matching grant, either directly or by way of some form of tax abatement, to demonstrate the public purpose of the bond financed facility; or a requirement that all tax exempt industrial revenue bonds be general obligation bonds; or a requirement that the volume of such bonds be subject to a state-by-state ceiling as was provided by Congress last year with respect to mortgage revenue bonds. In addition, consideration should be given to a reporting requirement for all small issues. As we consider these and other modifications, we will be mindful of the need to be certain that changes to the small issue provisions do not discriminate against the development activities of particular areas of the country.

Changes in the rules that apply to exempt small issues may be necessary, but they should be undertaken only after a careful analysis of all of the issues. We stand prepared to assist this Subcommittee in their examination of these issues.