SEPARATING PUBLIC- AND PRIVATE-PURPOSE TAX-EXEMPT BONDS

by Dennis Zimmerman

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In this article, Zimmerman argues that there are too many tax-exempt bonds because the officials responsible for their issuance regard them as being costless. He also argues that the definition of public purpose is properly left to the state and local officials, and he believes that the flexibility allowed to state and local officials in deciding who should use the bond proceeds is proper. He would deal with the problem of too many bonds by requiring that state and local government taxpayers assume financial responsibility for the bonds issued. If they did, then the concerns over too many bonds and the definition of public purpose would likely disappear.

Table of Contents

I. Introduction 509
II. An Analysis of Current Policy 510
A. Lack of State and Local Financial Responsibility 510
B. State-Local Initiative in Defining Public Purpose 511
C. Flexibility in Who Uses the Bond Proceeds .. 511
III. An Analysis of Current Reform Proposals 512
IV. An Alternative Proposal 512

I. Introduction

Tax-exempt bonds have been used for an ever-expanding variety of purposes over the past 20 years. State and local governments have issued bonds and used the proceeds on behalf of such entities as private business for fast-food restaurants and heavy industries; private nonprofit institutions for education and medical care; individuals for student loans and owner-occupied housing; and communities for airports and sports stadiums.

Congress has made repeated efforts to restrict the growth of what some claim are "private-purpose" tax-exempt bonds. Major legislative action began with the Revenue and Expenditure Control Act of 1968, which placed restrictions on the issuance of industrial development bonds (IDBs). Subsequent legislation has addressed bond use for such purposes as student loans and mortgage subsidies. The most recent effort to restrict the growth of private-purpose bonds was the state per capita volume cap on IDBs enacted in the Deficit Reduction Act of 1984. The current consideration of tax reform already has four versions of how best to limit the volume of private-purpose bonds, ranging from the very restrictive Administration proposal, through the successively less restrictive House (H.R. 3838) and Senator Packwood proposals, to the near-current-law Senator Durenberger proposal.

The fact that private-purpose bonds are again a focal point of the current tax reform effort is eloquent testimony to the intractability of this issue. The Administration and some members of the Congress decry the revenue cost of the subsidy, particularly when one considers the sometimes tenuous relationship of benefits to the public good. In contrast, the state-local sector, the securities industry, and some members of Congress see public benefits in almost any use of bond proceeds. They claim any restrictions represent one more instance of federal government intrusion into state and local rights and a substitution of federal vision of the public good for that of duly elected state and local officials. This article suggests both perspectives have considerable merit, and that both sides could be accommodated with a different approach to revising the tax treatment of tax-exempt bonds.

One factor largely ignored in the . . .tax-exempt bond debate is the extent of the state and local sector's financial responsibility for these bonds.

This article evaluates the desirability, from an economic perspective, of altering the tax treatment of three current features of the tax law identified as being important to the growth of private-purpose bonds: lack of state and local financial responsibility for debt service, state and local initiative in defining public purpose, and flexibility in who uses bond proceeds. It is noted that previous and current reform efforts focus on restricting the latter two features while largely ignoring the role of financial responsibility. The article suggests that reform efforts to separate public-

from private-purpose bonds might beneficially take exactly the opposite tack—increase the degree of state and local financial responsibility, and permit both state and local initiative in defining public purpose and flexibility in who can use bond proceeds.

II. An Analysis of Current Policy

A. Lack of State and Local Financial Responsibility

One factor largely ignored in the public- versus private-purpose aspects of the tax-exempt bond debate is the extent of the state and local sector's financial responsibility for these bonds. The lower interest rate created by the tax exemption privilege is, in effect, a subsidy paid traditionally to increase state and local capital formation for roads, public schools, sewer systems, and other public infrastructure. But state and local officials have been increasingly pressured by the nonprofit sector, private individuals, and businesses to use the proceeds of these lower cost tax-exempt bonds for their benefit.

Officials have been increasingly pressured...to use the proceeds of these lower cost tax-exempt bonds for [the benefit of nongovernmental persons.]

It is, of, course, quite understandable why these other groups desire access to lower cost tax-exempt financing. The question is why state and local governments seem to feel it is in their interest to share this low-cost financing with other, technically ineligible, parties. If state and local governments did not act as a conduit for nongovernmental users, the state and local sector would possess a monopoly over tax-exempt financing.

The answer lies in the relationship between the issuing government's perception of its costs and benefits. State and local officials tend to view these nongovernmental bonds as being costless to their taxpayers, and thus to themselves. To understand this thinking it is necessary to understand the distinction between a general obligation (GO) bond and a revenue bond. The GO bond pledges the tax revenues of the state and local government as payment for the bond proceeds and interest. A revenue bond usually pledges only the revenue stream generated by the project being built or revenue from other projects, but not the government's taxing power.[1] Almost all of the activities which are the subject of limitation efforts are financed with revenue bonds.

Current law does impose a relatively weak financial responsibility test for tax-exempt status of private-purpose bonds. If more than 25 percent of the bond proceeds are used in a trade or business, then not more than 25 percent of the debt service may be secured by the property or revenues of an entity engaged in a trade or business. This seems to suggest bonds are eligible for tax exemption if the issuing entity (frequently an agency or authority created by a government) assumes responsibility for 75 percent or more of the debt service. But this simply means the government pledges user charges or revenues from the project being built or from other projects. It does not necessarily mean that the state or local government must pledge to repay the debt service with tax revenues if these pledged project revenues are inadequate.

Should, for example, a hospital built with revenue bond proceeds be underutilized and revenues be inadequate for full payment of proceeds and interest, the issuing government is under no obligation to use tax revenues for the shortfall. The cost of an unsuccessful project thus falls upon bondholders in the form of defaulted or delayed payments. Since the cost of the interest subsidy falls upon *federal* taxpayers in the form of foregone tax revenues, state and local government officials act as though their middleman role generates no costs. These officials also appear unimpressed with the reasoning that nongovernmental users increase demand for tax-exempt funds and thereby raise the interest cost for financing traditional public sector infrastructure.

State and local officials do, however, see private-purpose bonds as beneficial. Even in a case in which all the direct benefits accrue to the nonprofit or private entity receiving lower cost capital, the state-local government official sees the bond proceeds as generating increased investment and jobs in the community. To the state or local official, it is largely irrelevant that these "benefits" may represent a reshuffling of the geographic location of these jobs rather than a net addition to the number of jobs nationally.[2]

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Standard economic theory suggests that any good priced at zero (or even at less than its marginal cost of production) will generate excess demand. Since the state and local sector does not bear (or does not believe itself to bear) any (or some) of the costs of tax-exempt revenue bonds, the sector is very likely to issue a volume of bonds which on the margin are likely to cost society more than it values the public (private?) goods being produced. The roots of continual congressional attention to these bonds thus are planted in the fertile soil of inadequate state and local financial responsibility.

[1] One should not conclude from this discussion that revenue bonds were developed as a vehicle for diverting tax-exempt bonds to the use of the private sector. The development of revenue bonds probably owes more to constitutional and legislative restrictions on state and local governments' ability to incur general obligation debt in relation to the size of their tax base. The revenue bond allows bonds to be issued which do not require referenda or do not count as part of a debt ceiling, because tax revenues are not pledged for payment.

[2] For a more complete discussion and some empirical work concerning these issues, see U.S. Library of Congress, Congressional Research Service, *Limiting the Growth of Tax-Exempt Industrial Development Bonds: An Economic Evaluation*, Report No. 84-37 E, by Dennis Zimmerman, Washington, 1984, 37 p.; and Michael J. Stutzer, The Statewide Economic Impact of Small-Issue Industrial Revenue Bonds, *Federal Reserve Bank of Minneapolis Quarterly Review*. Spring 1985. 12 p.

B. State-Local Initiative in Defining Public Purpose

A second important factor is who establishes activities as public purpose. Current policy proceeds in two steps. In the first step, state and local officials make the *initial* decision to finance a particular activity with tax-exempt bonds, and proceed to issue bonds for that purpose. This decision establishes the activity as a public purpose (or, at least, as an activity eligible for tax-exempt financing). Such state-local initiative is supported on both economic and legal grounds. First, it is consistent with the view that state and local officials are better able to discern their constituents' preferences for public goods than are more geographically remote federal officials. Second, it is consistent with the belief of many that the Constitution protects state-local governments against federal intrusion in their financial affairs. In this view, the Constitution precludes the federal government from taxing the interest income from state and local bonds, whatever their purpose.

The definition of public purpose . . . probably is best suited to the political arena.

The second step in the definition of public purpose is the oft-exercised congressional right to an after-the-fact review of these purposes. It is tempting to interpret these persistent efforts to limit the use of tax-exempt bonds for some activities as a congressional assertion that it believes itself to be a better judge of citizens' preferences for public goods than are state and local officials, and that it rejects the constitutional separation of powers argument.

Inspection suggests this not to be the case. A practical tool for determining the appropriate federal role in subsidizing state and local provision of public services does not exist. Economic theory can be used to explain the conditions under which federal subsidy is desirable. But it is not easy to quantify these conditions in a manner which the Congress can use to determine public purpose.[3] The definition of public purpose is necessarily elastic and subject to continuous reexamination, and is probably best suited to the political arena.

In this arena, the Congress has never seriously considered cutting back on its support for traditional state and local functions, such as roads, schools, and sewers. And many of the supposed "private-purpose" activities financed with tax-exempt bonds, such as economic development, student loans, owner-occupied housing, and even "small-issue" assistance to private businesses, receive federal support from the expenditure side of the budget or from other tax subsidies. Congress has, by prior actions, implicitly certified some amount of most of these activities as serving public purposes.

Thus, when one looks at the spectrum of what the federal government is engaged in, the federal and state-local sectors' visions of public purpose seem markedly similar. The federal tax reform focus on definition of public purpose may well be misplaced. Rather, the problem seems to be that subsidizing with tax-exempt bonds dilutes congressional control over the *amount* of the subsidy. It is a volume problem that may have more to do with excess use attributable to the absence of state-local taxpayers' responsibility for bond costs than it does with state and local initiative in defining public purpose.

C. Flexibility in Who Uses the Bond Proceeds

The third important feature of current tax policy responsible for the growth of private-purpose bonds is flexibility in who actually uses the bond proceeds. Current policy developed from a system in which any agent or entity—government, business, individual, or nonprofit entity—could use the proceeds.

This flexibility is consistent with economic theory. The economic rationale for state and local government involvement in the decisions of the private market is straightforward. The private sector provides too much or too little of some products or activities. Too much is provided when some costs of producing a good are not included in its selling price; too little is provided when some benefits from a good are enjoyed without having to buy the good. State and local government adjustment of the amount of these goods is sometimes justified to account for these "external" benefits and costs in order to maximize social benefits.

This explanation does not prescribe the form of the government intervention. Direct government provision is only one alternative for altering the amount of an activity. The government could use the proceeds to build a facility and contract for private sector management. The government could also regulate or subsidize a privately owned and managed facility, or use the proceeds to subsidize private sector capital formation. The important point is that any of these alternative types of intervention can use tax-exempt bonds to reduce the cost of capital and increase output of a good or service judged to serve a public purpose. It does not matter whether the proceeds are used directly by the government, or by businesses, individuals, and nonprofit entities. The choice among alternative agents (users of the proceeds) should depend upon their relative cost in altering output. In principle, flexibility in who uses bond proceeds is desirable.

The third important feature of current tax policy . . . is flexibility in who actually uses the bond proceeds.

Previous reform efforts have imposed some restrictions on this flexibility. Tax exemption is denied if more than 25 percent of the bond proceeds are used in a trade or business of a person other than a government or exempt organizations, unless the 25 percent financial responsibility test described above is met; or if five percent or more of bond proceeds finance loans to persons other than governments or exempt organizations. Exceptions are provided for certain specified activities, presumably those

[3] The economic justification for federal subsidy of the state-local sector is discussed more thoroughly in U.S. Library of Congress, Congressional Research Service, *Tax Reform and Federal Subsidy of the State-Local Sector: Is There a Role for State-Local Tax Deductibility?* Report No. 85-515 E, by Dennis Zimmerman. Washington, 1985. 14 p (Reprinted in *Tax Notes*, Vol. 26, No. 5, February 1985).

which are considered to be most nearly for public purposes.

III. An Analysis of Current Reform Proposals

It is not necessary to go into great detail on the four major reform proposals in order to illustrate how they follow the path of prior reform efforts. The Administration proposal would disallow (with some qualifications) tax exemption if more than one percent of bond proceeds is used directly or indirectly by a person other than a state or local government. In effect, this would impose a governmental use-of-proceeds rule that virtually requires direct government provision of goods and services as a proxy for a definition of public purpose.

The House bill would restructure the public versus private definitions in the law. It would change the 25 percent rule for use of bond proceeds to 10 percent and eliminate the 25 percent rule for financial responsibility. It would strengthen the volume limitations and make a substantial effort to redefine many types of bonds in terms of whether they serve an essential purpose (and are, therefore, not subject to the volume cap) or a nonessential purpose (and are, therefore, subject to the volume cap).

Senator Packwood's and Senator Durenberger's proposals would do similar types of things, but their visions of what satisfies a public purpose differ in many respects from the House bill and from each other. For example, Senator Packwood would *include* under his volume cap facilities for multifamily housing, sewage and solid waste disposal, and water; Senator Durenberger would *exclude* these facilities from his volume cap.

All of these proposals have different visions of what constitutes acceptable public purposes. It is quite likely that the taxpayers in numerous state and local governments have similarly varied opinions about what constitutes a public purpose. Attacking the problem in this way does not accommodate the diversity found in state and local governments with respect to the division of responsibility between the public and private sectors.

The absence of state and local taxpayers' financial responsibility...encourages...[the issuance] of too many bonds....

The point here is that none of these proposals attempts to change the degree of state-local taxpayers' financial responsibility. Instead, all of these proposals would reform the current system either by redefining what types of activities satisfy a public purpose (thereby reducing state-local initiative in defining a public purpose), or by restricting state and local flexibility in how they deliver their public services (thereby presumably discouraging efficient provision of public services).

IV. An Alternative Proposal

The preceding discussion supports several findings. First, given the subjective nature of determining what serves a public purpose, state and local initiative in defining public purpose is probably desirable from both an economic and legal perspective. Furthermore, the fact that Congress provides expenditure and other tax subsidies to most of the activities the state and local sector finances with tax-exempt bonds suggests these activities do satisfy a public purpose, even from the federal perspective. Second, flexibility in who uses the bond proceeds makes economic sense. And third, the absence of state and local taxpayers' financial responsibility for revenue bonds encourages the state and local sector to issue too many bonds for these public purposes.

All bonds...which guarantee state and local taxpayers' financial responsibility...would be tax-exempt.

An alternative reform proposal for consideration can be fashioned from these findings. First, all bonds issued by state and local governments (or their duly created agencies or authorities) which guarantee state and local taxpayers' financial responsibility for debt service would be tax-exempt. These bonds could be labeled either GO or revenue bonds, as long as a revenue stream inadequate to service the bonds triggered state and local government payment from other resources, including tax revenue if necessary. Second, all bonds assuming such financial responsibility would be free of any restrictions on types of activities and on who uses the proceeds.

This alternative formulation gives something to and takes something away from both the federal and state-local governments. First, in exchange for state and local governments placing their tax base at risk for what they regard as public-purpose projects, these governments are given the right to define public purpose and provide public services in what they consider to be the most efficient manner. Second, in exchange for federal government withdrawal from defining public purpose and specifying who can use bond proceeds, it knows that state and local taxpayers must balance the risk of future potential tax payments with the benefits they expect to obtain from bond issues.

This proposal does raise some problems. The immediate problem from a federal perspective is the revenue uncertainty it would create in the context of tax reform. We do not know how sensitive taxpayers are to increased costs and how quickly state and local officials respond to the concerns of their taxpayers. We do not, therefore, know how much the bond volume would decrease and federal tax revenues increase. This is an important consideration in a revenue-neutral tax reform. There is, however, abundant evidence that state and local taxpayers take very seriously the potential claims of outstanding debt obligations on their tax base. Most state and local governments have constitutional and/or statutory restrictions on the issuance of debt with claims against the tax base, usually in the form of debt ceilings and referenda requirements. The prospect is good that financial responsibility would reduce bond volume.

From the state and local perspective, it is precisely these constitutional and statutory limitations which would cause a problem in the short run. These limitations would have to be changed before more bonds backed by tax

revenues could be issued. Resistance to changing these limitations is likely to be considerable. In fact, the limitations are at least in part responsible for the development of the revenue bond, which in many jurisdictions was a response to debt limit levels which were inadequate to enable issuance of bonds even for some traditional infrastructure. Although caution is called for when changing the rules of the game, consideration of such a federal policy change should not be precluded by current institutional arrangements.

The point of this proposal is, after all, to require state and local governments to carefully balance benefits and costs of bond issuance. This balancing does not occur with the revenue bond. If the "private-purpose" bonds now being issued are actually providing public services comparable in value to their potential call on the state and local tax base, the political will to alter the institutional rules of the game would be present.

These considerations suggest that such a scheme, if adopted, might be phased in over time. This would control the revenue loss problem and allow the state and local sector time for the necessary institutional adjustments.

Finally, the proposal could also be modified to allow for some revenue bond issuance as a fall-back position. For example, bonds lacking state and local taxpayers' financial responsibility could be made tax-exempt if their purpose was specifically approved by Congress *prior to* issuance. This would require Congress to engage in some of the same detailed definitional lawmaking as they now do. But the pressure for such exemptions would, hopefully, be diminished as many state and local governments attempt to avoid potential congressional difficulties by assuming full financial responsibility for their still-subsidized bonds. If the state and local sector really wants what it says, that is, minimal federal interference in their financial affairs, it is attainable.

PRIOR COVERAGE

For a prior special report on tax reform of tax-exempt financing, see "Substantially All of The Camel: Congress Revisits Section 103, Again," by Hugh M. Dougan, *Tax Notes*, March 24, 1986, pp. 1275-1293.

CURRENT AND QUOTABLE

British Oppose Packwood's FIRPTA Extension

Set forth below is the full text of an April 14, 1986 letter to Senate Foreign Relations European Affairs Subcommittee Chairman Larry Pressler, R-S.D., from British Ambassador Sir Oliver Wright, who opposes the Senate Finance Committee's proposed extension of FIRPTA to other stock dispositions. Wright agrees with Treasury, which opposes this and other treaty overrides cropping up in tax legislative proposals. The full text of Wright's letter has been placed in the May 5, 1986 Tax Notes Microfiche Database as Doc 86-3366.

My dear Senator:

Thank you very much for your letter of 27 March enclosing a copy of your letter to Senator Packwood about the Foreign Investment In Real Property Tax Act of 1980 (FIRPTA).

In the past, my government has expressed concern at the practical implications of the FIRPTA provisions for United Kingdom businesses, but we have not opposed the basic principles underlying the tax; nor, in this particular instance, is the U.K./U.S. Double Taxation Convention affected. Nevertheless, the proposal by the Senate Finance Committee to extend FIRPTA to dispositions of stock in companies other than real property holding companies would cause serious difficulties for the United Kingdom, and is contrary to internationally accepted principles (embodied in the OECD Model Tax Convention) for dealing with such transactions.

I fully agree with your more general point that unilateral amendment of bilaterally negotiated agreements can only undermine the certainty and protection which such agreements are intended to provide. Proposals involving override of the U.S./U.K. Double Taxation Treaty are in fact appearing with disturbing frequency in the House Tax Reform Act of 1985 (H.R. 3838) and in the Senate Finance Committee proposals for tax reform. While it is important to ensure—through the usual provisions of bilateral negotiation—that treaties are not abused through treaty-shopping or other devices, I strongly endorse the comments of the Secretary of the Treasury in a recent (7 April) letter to Senator Packwood and Representative Rostenkowski when he stressed that the Administration "strongly opposes treaty overrides in tax reform legislation."

The proposal...to extend FIRPTA to dispositions of stock in companies other than real property holding companies would cause serious difficulties for the United Kingdom....

I am copying this letter to Senator Packwood and all other members of the Senate Finance Committee; and to Secretary Baker.

Sincerely,

Oliver Wright
British Embassy