A corporate bond that, through the interaction of state and federal govern-ments, is treated as a municipal bond for federal income tax pur-pose.1 The bonds are termed small-issue because they are granted tax exemption through a provision that limits their size to $10 million. Typically, a local government issues the bonds and constructs a plant or purchases equipment with the pro-ceds. The local government in turn leases the new facilities to a private firm, using lease installments to payoff the principal and interest on the bonds. Since the interest earned on IDBs is not taxable under current law, the bond purchaser usually is willing to lend the money at lower rates than he would demand if the bonds were taxable. The credit of the issuing government is unaffected by this transaction, because the bonds are backed by the revenue of the leasing firm, not by the taxing power of the local government. If the leasing firm goes bankrupt, the issuing government is not required to pay off the bonds. As a part of its recent effort to make a “down payment” on the fed-eral deficit, Congress has revised the debate about federal tax incentives for business investment. In formulat-ing new limits for small-issue IDBs, Congress has raised anew many concerns that the appropriateness of IDBs as an instrument

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2. At one time, a distinction was made between industrial revenue bonds and industrial develop-ment bonds, based on whether the issuing jurisdic-tion used its tax-exempt authority to secure the bonds. Since local governments now rarely back the bonds in this way, the distinction has faded and the two terms have become synonymous.

3. See CBO, Small Issue Industrial Revenue Bonds, 1978-79, CBO data for these years were not provided observations. The correlation between per capita income and IDB use was 0.273 and was significant at the 1 percent level. The pattern of cyclical peaks and troughs as the national income, however, might be more useful to categorize firms by their existing sales volume or size of work force, rather than by their capital spending. The size of capital investment stim-u-lated by IDBs directly affects the number of jobs created. By limiting capital expenditures to $10 million, the community gains less employ-ment for each IDB dollar than it might under another plan. For example, if cities were to use IDB financing to lure firms that plan to build facilities costing more than $10 million, the IDB program might generate more jobs. In addition, by including expenditures for three years after the IDB issue date in the capital expenditure limit, the current law could prohibit a rapidly expand-ing firm from building new facilities until the three-year period is over.

4. The new law restricts this loophole somewhat by limiting the total amount a single issuer of IDBs may have outstanding at one time to $40 million. 9. CBO, Small Issue Industrial Revenue Bonds, p. 23.

5. The single largest segment of the private-purpose, tax-exempt bond market—one more than one-fifth of the total volume of new issues—is made up of small-issue industrial develop-ment bonds (see table 1). An industri-al development bond (IDB) is really

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IDB financing was not a major factor expanded dramatically, from $366,000 rates on all municipal issues. Third, believed that such firms did not need the average size of the issues had a 17-fold increase. It became clear that IDBs bonds (like those used for schools) caused concern in Congress, for prior to the issuance of the IDB. By the 1968 act allowed IDBs to be reported to the Internal Revenue Service. In addition, specific recreation and entertainment facilities, including the three listed above, were entirely prohibited from IDB use. Congress also enacted a sunset provision that would remove the tax-exempt status of all IDBs, beginning in 1987. As part of its effort to reduce the federal deficit, Congress recently approved further tightening provisions, one of which limits the combined volume of IDBs and student-loan bonds that may be issued in each state to $150 per person or $200,000, whichever is greater. This cap applies to all IDBs, not just small issues, with the exception of multifamily housing issues and bonds used to finance convention centers, docks, transportation facilities, and wharves. However, these limitations are not as restrictive as they might seem. The two-part nature of the cap appears to guarantee that almost all states will be able to issue the same volume of bonds as before, so the legislation affects only the future rate of growth of IDBs. Moreover, bonds that are sold by the end of 1984 for projects approved before June 19, 1984, are exempt from the provision. As a final weakening measure, Congress excluded manufacturing projects from the sunset provision of 1982, prolonging the tax-exempt status of these bonds until 1989.

Finding a Target: Problems in Small-Issue IDB Use

IDBs as national policy. Suppose for a moment that the federal government cared only about the nation's aggregate income and employment and not about their geographic distribution. As a national policy, it would be difficult to justify the use of IDBs because there are more efficient ways to reach the various goals for which IDBs were established. For example, if the goal is to stimulate business investment generally, targeting the funds through an investment tax credit would produce a much greater reduction in the cost of investment capital without changing the revenue loss to the U.S. Treasury. Much of the money lost through IDBs simply reduces the taxes of high-income investors, without affecting investment. Suppose, for example, that tax-exempt issues are yielding 75 percent of their return on taxable bonds. Then a taxpayer in the 25 percent marginal tax bracket would be indifferently taxed by taxable and tax-exempt bonds. Anyone with a marginal tax rate higher than 25 percent would purchase tax-exempt bonds and receive a tax subsidy, in the sense that he or she would be paid an interest rate higher than necessary to ensure purchase of the tax-exempt securities. Or, to put it another way, purchasing the bonds would enable anyone in these higher tax brackets to lower his or her tax rate to 25 percent (the interest foregone on the tax-exempt securities).

Since the exact income distribution elements of the tax-exempt market are unknown, the precise amount of this slippage is impossible to calculate, but it is positive. However, in the future, the revenue losses from IDBs, the Congressional Budget Office suggests that the average small-issue IDB investor has a marginal tax rate that is close to 40 percent. This means that, in this example, three-eighths of the revenue lost through IDBs (25 percent divided by the taxpayer's 40 percent tax rate) benefits high-income investors.

In response to these criticisms, Congress attempted to trim IDB growth by establishing two criteria for tax exemption—purpose and size. The Revenue Expenditure and Control Act of 1968 revoked the tax exemption for IDBs of large size, except for quasi-public purpose projects. This exemption includes airports, docks, mass transportation and parking facilities, plant and equipment for local utilities, residential housing, sewage and solid waste disposal facilities, stadiums, trade and convention centers, and wharves. Also covered are bonds to finance the purchase of air- and water-pollution-control equipment and bonds used to acquire and develop industrial parks. In addition, the 1968 act allowed all IDBs of less than $1 million to retain their tax-exempt status, and these bonds became known as small-issue IDBs. Subsequent amendments to the act raised the ceiling on small-issues to $5 million, and then to $10 million, but stipulated that a firm receiving the exemption on an issue greater than $1 million must not spend more than $10 million on capital facilities in the issuing jurisdiction. (Projects funded with the assistance of Urban Development Action Grant money may spend $20 million.) The $10 million limit applies to the firm's total expenditures (not just those financed by the bond) on plant and equipment over six years, beginning three years prior to the issuance of the IDB. By amending the IDB act in 1978, Congress sought to provide greater help to state and local governments that were trying to develop their economies, while also restricting IDB assistance to small firms.

After the 1968 law was passed, IDB sales took a nosedive and then began to climb upward again, partly because issuers began to recognize the breadth of activities that could be financed under the small-issue exemption. From its traditional use to support industrial activities, IDB financing spread increasingly into commercial and retail projects. Reports of IDBs being used to finance massage parlors, racquet clubs, and race tracks motivated Congress to include additional trimming measures in the Tax Equity and Fiscal Responsibility Act of 1982. This law restricted IDB financing for automobile dealerships, recreation and entertainment facilities, and restaurants, requiring for the first time that IDB issues be reported to the Internal Revenue Service. In addition, IDBs and other private-purpose bonds apply to the firm's borrowing power of state and local governments to diversify its Depression-stricken, agricultural-based economy. Use of the bonds spread slowly, however; by 1956, only Alabama, Kentucky, and Mississippi had authorized their issuance. In the 1960s, IDB financing became popular and spread to the East and the Midwest, where it was embraced as a means of attracting new industries and preventing old ones from moving to the Sunbelt. By 1968, the volume of IDBs issued had climbed to $1.4 billion. The growth in volume of the bonds caused concern in Congress, for three reasons. First, the $1.4 billion was a loss to the U.S. Treasury through the tax exemption was considered. Also, there was alarm that IDBs threatened the market for more traditional public-purpose municipal bonds (like those used for schools and highways). This two-part nature of the cap appears to be unclear. Whether these groups are favored over others, since all 50 states have enacted IDB laws, new federal government has made few legislative efforts to target the funds. For example, there is no system among communities using IDBs to ensure that distressed areas receive all or even most of the aid provided by IDBs. In fact, based on CBO estimates of IDB sales from 1975 to 1980, there is a positive and significant correlation between the population of a state and the volume of IDBs sold. The correlation is higher than that of some other factors that might be expected to affect the use of IDBs, such as the tax base in the state. However, it is impossible to calculate, but it is positive. However, in the future, the revenue losses from IDBs, the Congressional Budget Office suggests that the average small-issue IDB investor has a marginal tax rate that is close to 40 percent. This means that, in this example, three-eighths of the revenue lost through IDBs (25 percent divided by the taxpayer's 40 percent tax rate) benefits high-income investors. On the other hand, it could be that the correlation between IDB sales in a specific state and state per capita income. In addition, no significant correlation exists between IDB use and state unemployment. Thus, neither of these standard measures of economic distress—income and employment—suggests that IDB dollars typically find their way into economically disadvantaged states. On the contrary, it seems likely that IDBs are used disproportionately by the most distressed areas within each state as the correlation is misleading. This seems unlikely, however, since only a few states direct their IDB funds to economically troubled areas. Similarly, IDBs were originally intended to diversify local economies, 3. See 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.
6. To reduce transactions costs, most IDBs are privately placed with banks and other local investors, not sold on organized exchanges. Short of contacting each of these investors individually, establishing the magnitude of IDB sales prior to 1982 is a matter of luck and historical accident. Only hampered research into the impact of IDBs in a variety of areas, including interest rates.