Impact of Congressional Action on Tax-Exempt Bonds

by Bill Finger

Tax-exempt bonds are an integral part of the federal tax code. In the fall of 1986, President Reagan is expected to sign a major new tax law with the most sweeping changes in a generation. But before 1985, when Congress began considering this tax-reform package seriously, industrial development bonds were part of a more narrow Congressional debate.

The debate focused on whether industrial development bonds adversely affected the overall tax-exempt bond market by increasing the cost of municipal bonds for such public purposes as schools and roads. Critics of industrial development bonds contended that IDBs increased the overall volume of tax-exempt municipal securities, which in turn caused the interest rate for all tax-exempt paper to increase.

"The removal of tax exemption from private purpose municipal bonds would reduce significantly the cost of financing traditional public services," wrote Thomas R. Dye, a professor of government and policy sciences at Florida State University in an article published early in 1985.[1] Dye calculated that 62 percent of new municipal bonds are for private purposes (small-issue IDBs, pollution control, housing, private hospitals, and student loans), and only 38 percent for traditional public purposes (water and sewer, schools, police, fire, etc.). "The effect of removing 62 percent of the supply of new municipal bonds from the market would have a drastic effect in lowering yields," wrote Dye.

Others disagree, emphasizing that the biggest impact on the sale of tax-exempt bonds comes from the *demand* side, not from the *supply* side. In other words, the interest rate hinges more on who wants to buy the bonds than on competition in the supply between industrial development bonds and general obligation bonds. Three key factors determine the demand for tax-exempt bonds, says Richard Geltman, staff director of the committee on economic development and technological innovation for the National Governors' Association: 1) the entire bond market, including *taxable* bonds, 2) the sharp increase in recent years in the amount of borrowing by the federal government, and 3) the availability of other tax shelters.

The Council of Industrial Bond Issuers, a trade association promoting IDBs, takes Geltman's point a step further. "Fears that small issues will 'crowd out' traditional state and local borrowing are not sustained by the evidence," concluded the council in a 1986 report. "The market for tax-exempt bonds generally has become dominated by private individuals who in recent years have purchased up to 81 percent of new bond issuances. In contrast, the survey found that over 90 percent of small issues are bought by commercial banks, S&Ls, insurance companies, and institutional investors who, in turn, hold virtually all the bonds to maturity."[2]

Tax Reform Takes Center Stage

In 1985, such questions as whether IDBs compete with general obligation bonds in the market began to be absorbed into the much larger tax-reform debate in Congress. In December 1985, the U.S. House passed HR 3838, which had an immediate effect on the bond market—even though final passage into law still appeared uncertain.

"HR 3838 has had a chilling effect on issuing even the most traditional public purpose bonds for such items as schools or prisons or water and sewer, much less industrial revenue bonds," said Geltman in an interview, before the U.S. Senate Finance Committee approved its version of HR 3838. "If HR 3838 becomes law, it would severely limit the ability of municipalities to issue many kinds of municipal bonds," added Geltman.

In North Carolina, State Treasurer Harlan Boyles and others expressed similar concerns over how the House-passed bill would affect *general obligation bonds*. At the Feb. 20, 1986 meeting of the N.C. Association of County Commissioners Board of Directors, Boyles warned of the potential impact that Congressional action could have on counties and municipalities. "Basically, this bill (HR 3838) would take our feet out from under us,"

Boyles told the group. "It would make it almost impossible for local governments to qualify for tax-exempt bonds."

Then on March 12, 1986, the N.C. Association of County Commissioners ran an editorial in its newspaper, *County Lines*, called, "Tax Reform Act May Finish Counties' Use of Bond Issues." The editorial discussed six components of HR 3838 that could limit the issuance of general obligation, or public purpose, bonds. "The Association joins with the National Association of Counties in opposing these (six) provisions of HR 3838," said the *County Lines* editorial. "Much of the public building needs in the state have traditionally been financed by tax-exempt bonds, including highways and schools. The state needs the option of funding highways with bonds, just as counties must have the option of funding schools, water-sewer facilities, hospitals, and jails with bond issues. A pay-as-you-go plan simply is not feasible for those counties with immediate building needs."

In the April issue of "The State Treasurer's Quarterly," a newsletter sent to all counties, municipalities, and state agencies, Boyles explained the provisions and ramifications of HR 3838. The bill "would have a very negative effect upon North Carolina and, of course, upon all of the other states as well," explained the newsletter. "From the philosophical standpoint, passage of such a law as HR 3838 would upset, and drastically change, the principle of mutual accommodation between the federal and state government in the matter of revenues for the public benefit. The bill would make the most significant and adverse changes ever enacted in the area of state and local government finance."

Tax Reform Passes With Surprising Ease

The commentary in North Carolina reflected the strident tone of the national debate. "Municipalities, counties, and states are all against the changes (regarding tax-exempt bonds)," said Geltman before the Senate Finance Committee took action. "Nobody's for these changes." But the overall tax reform legislation must be "revenue neutral" in order to float politically, Geltman pointed out. Private sector interests—from timber to oil—lobbied hard in the Senate Finance Committee to get tax breaks put into the bill. To make up for the revenues *lost* to the tax breaks, the private interests pointed to the limitations on tax-exempt bonds as a place to gain revenues. "It came down to state and local governments versus the private interests," said Geltman.

As the various interests began staking out their turf in the Senate Finance Committee, the traditional location for securing special tax breaks, the committee chairman, Sen. Bob Packwood (R-Ore.), surprised the competing parties by getting a bill out of committee quickly with relatively few special-interest concessions. Then in June 1986, the full Senate passed the bill with little debate, and the bill was highballing down the tracks towards final adoption.

Before the House-Senate conference committee even went to work in mid-July, a compromise appeared to be in the works among the House and Senate leaders and the Reagan administration. With the Labor Day recess approaching and November elections ahead, all parties seemed eager to get a consensus bill back to both chambers as early as possible. With such a complex bill, attention inevitably centered on the individual and corporate income taxes, not on tax-exempt bonds. The House and Senate bills had several critical differences concerning tax-exempt bonds, but they were addressed primarily through the negotiation process over the higher-profile changes in corporate and individual income taxes.

On August 17, as Congress adjourned for a three-week recess, the committee agreed to a final tax-reform bill, including provisions concerning tax-exempt bonds. The agreement puts constraints on both traditional public purpose bonds (for schools, roads, etc.) and on industrial development bonds. But the initial fears that general obligation bonds could no longer be issued were alleviated somewhat. Some of the severest restrictions on general obligation bonds—which State Treasurer Boyles and others identified early in 1986—were relaxed (especially the strict reporting requirements), but the overall demand for tax-exempt bonds may still be reduced by the law.

The changes in the tax laws in the agreement are complex. Accountants, economists, bond counsels, and other financial experts will spend months analyzing all its ramifications. Highlighted below are the most important features of the bill—as it stood on September 10, 1986—concerning industrial revenue bonds in North Carolina:

- *There is a lower limit on overall volume for*

most types of non-essential bonds, including industrial revenue bonds.[3] The conference committee agreed on a limit of $75 per capita for each state, or $250 million—whichever is higher—through December 31, 1987, for certain types of tax-exempt bonds. In North Carolina, that limit would be about $484 million.

As of September 1, the exact types of bonds covered by this cap were not clear from the conference committee agreement, says Everett Chalk of the State Treasurer's Office. "The cap will probably result in a lower volume of IRBs being issued in North Carolina," says Chalk. "We'll probably have to pick and choose which projects we will approve." Because North Carolina does not allow industrial revenue bonds for non-industrial uses, "we will not experience nearly as much of a change as will other states," adds Boyles.

• *The incentives for buying tax-exempt bonds are reduced, for two reasons.* First, banks use borrowed money to buy tax-exempt bonds; under the old law, they were able to deduct most of the *interest they paid* on that borrowed money. Under the new bill, banks can no longer deduct this interest. Second, under the old law, those who bought bonds—and hence *earned interest* on that investment—did not have to pay federal taxes on that interest income. Under the new bill, this interest income may be taxable for individuals and corporations under new alternative minimum taxes. If a company or individual must calculate taxes under these provisions, bond interest income must be included. Put another way, if an individual or company is going to pay federal taxes under the alternative minimum tax, the individual or company will not be able to use tax-exempt bonds as a tax shelter.

While these provisions do reduce incentives for investors to buy tax-exempt bonds, the incentives for many other investments have also been reduced. Hence, some analysts believe that tax-exempt bonds could remain an attractive investment.

• *The sunset provision for small-issue industrial development bonds used for manufacturing and agricultural purposes is Dec. 31, 1989.* There is a sunset provision of Dec. 31, 1986 for IDBs used for commercial, wholesale distribution, and pollution-control bonds (for air and water). Before this tax bill, Congress had passed a Dec. 31, 1988 sunset for small-issue IDBs for manufacturing projects. By delaying this sunset provision one year, proponents of small issue IDBs have an additional year to try to save the program in Congress.

FOOTNOTES

[1]Thomas R. Dye, "Tax Reform and Municipal Financing: Dramatic Transformation Possible," *National Civic Review*, June 1985, pp. 266-269.

[2]*Small Issue Industrial Development Bonds and the U.S. Economy*, prepared by the Developing Systems, Limited (DSL) Consortium for the Council of Industrial Development Bond Issuers, March 1986, pp. 6-7.

[3]The new tax bill establishes categories for *essential* and *non-essential* bonds. For more, see footnote 4, p. 13.

Exterior view of new $30 million Carolina Turkeys plant, financed partially with a $10 million industrial revenue bond, located in Duplin County.

Jack Betts