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# TAX REFORM PROPOSALS – XX

# HEARING

BEFORE THE

# COMMITTEE ON FINANCE
# UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

SEPTEMBER 24, 1985

**Tax-Exempt Bonds**

Printed for the use of the Committee on Finance

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# THE IMPACT OF TAX REFORM ON TAX-EXEMPT BONDS

TUESDAY, SEPTEMBER 24, 1985

U.S. SENATE,
COMMITTEE ON FINANCE,
*Washington, DC.*

The committee met, pursuant to notice, at 9:35 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman) presiding.

Present: Senators Packwood, Chafee, Durenberger, Symms, Grassley, and Bentsen.

[The press release announcing the hearing and background information on tax treatment of State and local government bonds follows:]

### TAX REFORM HEARINGS BEFORE THE FINANCE COMMITTEE TO CONTINUE IN SEPTEMBER AND OCTOBER

Further hearings before the Senate Committee on Finance on the President's tax reform proposal will continue in September and October, Chairman Bob Packwood (R-Oregon) announced today.

"The Committee made significant progress in its tax reform hearing schedule in June and July," Senator Packwood stated. "Although the Committee will focus much of its attention on deficit reduction in the month of September, tax reform hearings will continue and will take us further toward our goal of getting a tax reform bill to the President before the end of this session of Congress."

The hearings announced by Senator Packwood today include:

On Tuesday, September 24, the Committee will hear from public witnesses on the impact of tax reform on tax-exempt bonds.

On Thursday, September 26, public witnesses will present their views on the impact of the President's tax reform proposal on financial institutions and on the mining industry.

On Tuesday, October 1, the Committee will receive testimony on the impact of the tax plan on the insurance industry.

On Wednesday, October 2, witnesses representing the public will present testimony on the projected effect that tax reform will have on American business generally and, in addition, its impact on the foreign tax provisions.

On Thursday, October 3, the Committee will consider the views of public witnesses on the impact of the President's tax reform proposal on our nation's regulated industries, as well as those provisions relating to the United States' possessions and its territories.

All of the hearings scheduled by the Committee will begin at 9:30 a.m. in Room SD-215 of the Dirksen Senate Office Building.

# TAX REFORM PROPOSALS: TAX TREATMENT OF STATE AND LOCAL GOVERNMENT BONDS

FOR THE USE

OF THE

COMMITTEE ON WAYS AND MEANS

AND THE

COMMITTEE ON FINANCE

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

## INTRODUCTION

This pamphlet[1] was prepared by the staff of the Joint Committee on Taxation for the House Committee on Ways and Means and Senate Committee on Finance in connection with their respective reviews of comprehensive tax reform proposals. The pamphlet is one of a series of pamphlets regarding the effect of tax reform proposals. It describes and analyzes tax provisions and proposals relating to tax-exemption of interest on State and local government bonds, the treatment of bond-financed property under other provisions of the Internal Revenue Code, and other related matters.

The pamphlet describes present-law tax provisions, the tax reform proposal made by President Reagan ("The President's Proposals to the Congress for Fairness, Growth, and Simplicity," May 1985, referred to as the "Administration Proposal"), and Congressional proposals, identified by their primary sponsor(s).

The first part of the pamphlet is a summary of present law and the major tax reform proposals before Congress. Parts II through V provide a more detailed description of present law, legislative background, and the reform proposals. Part VI discusses issues related to the availability of tax-exempt financing, both generally and for private activities. Part VII provides statistical information related to the use of tax-exempt bonds, including information on volume of various types of financing, a profile of investors in tax-exempt bonds, and revenue analysis.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Tax Reform Proposals: Tax Treatment of State and Local Government Bonds* (JCS-23-85), July 16, 1985.

# I. SUMMARY

## *Present law*

Interest on obligations of States, territories and possessions of the United States, and the District of Columbia generally is exempt from Federal income tax (Code sec. 103). Similarly, interest on obligations of political subdivisions of these governmental entities is tax-exempt. Under this rule, State and local governments may issue tax-exempt bonds to finance public projects or services, including facilities such as schools, roads, and water and sewer facilities.

Additionally, State and local governments may provide tax-exempt financing for use by tax-exempt charitable, religious, scientific, or educational organizations (described in sec. 501(c)(3)) and for certain private activities (e.g., by means of industrial development bonds, student loan bonds, and mortgage subsidy bonds). Interest on bonds to finance private activities (other than the activities of nonprofit charitable organizations, described above) is taxable unless an exception is provided in the Internal Revenue Code for the specific type of financing. Three principal exceptions are provided under present law.

### *Industrial development bonds*

Interest on industrial development bonds (IDBs) is tax-exempt when the bonds are issued to finance (1) one of several enumerated exempt activities, (2) land for use as an industrial park, or (3) certain small issues for land or depreciable property. IDBs are obligations issued as part of an issue all or a major portion of the proceeds of which are to be used in a trade or business carried on by a nonexempt person and the payment of principal or interest on which is to be derived from, or secured by, money or property used in a trade or business. A nonexempt person is any person other than a State or local government or a tax-exempt charitable, religious, scientific, or educational organization (as described in sec. 501(c)(3)). Most IDBs, together with all student loan bonds, are subject to State volume limitations.

### *Mortgage subsidy bonds*

Interest on mortgage subsidy bonds (MSBs) is tax-exempt. MSBs may be issued as either qualified veterans' mortgage bonds or qualified mortgage bonds. Qualified veterans' mortgage bonds are general obligation bonds the proceeds of which are used to finance mortgage loans to veterans. These bonds may be issued only by States that had issued them before June 22, 1984; the bonds also are subject to special volume and other restrictions. Qualified mortgage bonds are bonds the proceeds of which generally are used to make mortgage loans to first-time homebuyers; these bonds are subject to separate State volume limitations and loans made with the bond proceeds are subject to several borrower-eligibility and targeting restrictions. Authority to issue qualified mortgage bonds expires after 1987.

### *Student loan bonds*

Interest on certain student loan bonds is tax-exempt. Only those student loan bonds issued in connection with the Guaranteed Student Loan and Parent Loans for Undergraduate Students programs of the U.S. Department of Education are eligible for tax-exemption.

All tax-exempt bonds are subject to arbitrage and certain other restrictions; additional restrictions apply to bonds to finance various private activities. Among these additional restrictions are information reporting requirements, a prohibition of advance refundings, and a requirement that arbitrage profits be rebated to the Federal Government in certain circumstances.

## *Proposals for Change*

### *Administration proposal*

The Administration proposal would limit tax-exemption to governmental bonds. Governmental bonds are defined as bonds no more than one percent of the proceeds of which are used, directly or indirectly, by a nongovernmental person.

The Administration proposal also would enact expanded arbitrage restrictions and information reporting requirements, and would prohibit advance refundings for all tax-exempt bonds.

### *Congressional proposals*

Both the Bradley-Gephardt (S. 409 and H.R. 800) and Kemp-Kasten (H.R. 2222 and S. 1006) tax reform bills would repeal the present-law tax-exemption for interest on IDBs, MSBs, student loan bonds, and bonds for charitable organizations (described in sec. 501(c)(3)).

## II. DESCRIPTION OF PRESENT LAW

Interest on obligations of States, territories and possessions of the United States, and the District of Columbia generally is exempt from Federal income tax (Code sec. 103). Similarly, interest on obligations of political subdivisions of these governmental entities is tax-exempt.[2] In determining whether interest on a particular obligation is tax-exempt, a three-part inquiry is necessary. First, the activity being financed, and thereby the type of bond being issued (e.g., general government financing, industrial development bond, etc.), must be determined. The type of bond is determined by the use of the bond proceeds. Second, the authority of the issuer to undertake the tax-exempt debt must be established. Finally, compliance with In ernal Revenue Code rules governing tax-exempt bonds for the activity being financed must be established.

### A. Activities for Which Tax-Exempt Financing May Be Provided

#### *Obligations for exempt entities*

#### *General government operations*

State and local governments may issue tax-exempt bonds to finance general government operations and services, such as schools, courthouses, roads, and governmentally operated water, sewer, and electric facilities, without regard to most of the restrictions that apply to bonds used to finance private activities. Additionally, these governments may issue notes in anticipation of tax or other revenues (so-called tax anticipation or revenue anticipation notes (TANs or RANs)). The amount of such advance borrowings may not exceed projected cash flow shortfalls over a specified period.

#### *Installment sales agreements and other "non-bond" financing by State and local governments*

In addition to issuing bonds as evidence of indebtedness, State and local governments may undertake debt, the interest on which is tax-exempt, by means of installment sales contracts or finance leases. For example, a State or local government may purchase road construction equipment pursuant to a lease purchase agreement or an ordinary written agreement of purchase and sale. Interest paid on such acquisitions is tax-exempt if (1) the agreement calls for payment of the interest,[3] and (2) the amounts are true interest (as opposed to other payments labeled as interest). *See*, for

[2] In this pamphlet, governments of States, U.S. possessions and the District of Columbia, and their political subdivisions are referred to collectively as "qualified governmental units."

[3] Section 483 provides generally that interest is imputed for tax purposes at a prescribed rate on deferred payment agreements unless a minimum rate is specified in the agreements. The minimum rate required to be specified for tax-exempt debt is zero. The effect of this zero minimum rate is that no interest is imputed under section 483 in the case of State and local government debt. (Treas. Reg. sec. 1.483-1(d)(3).)

example, Rev. Rul. 60-179, 1960-1 C.B. 37 and Rev. Rul. 72-399, 1972-2 C.B. 73.

### *Certain charitable organizations*

State and local governments may issue tax-exempt bonds to finance the activities of certain charitable organizations (described in sec. 501(c)(3)) on a basis similar to that for activities of the governments themselves. The beneficiaries of this type of financing frequently are private, nonprofit hospitals and private, nonprofit colleges and universities.

## *Industrial development bonds*

Industrial development bonds (IDBs) are obligations issued as part of an issue all or a major portion of the proceeds[4] of which are to be used in a trade or business carried on by a nonexempt person[5] and the payment of principal or interest on which is derived from, or secured by, money or property used in a trade or business. Interest on IDBs is tax-exempt only if the bonds are issued for certain specified purposes. Issuance of most IDBs and all student loan bonds (i.e., private activity bonds) is subject to State volume limitations. These limitations, and other rules applicable to IDBs, are discussed more fully in II.D. and II.E., below.

### *Exempt-activity IDBs*

One of the exceptions pursuant to which interest on IDBs is tax-exempt is where the proceeds of the bonds are used to finance an exempt activity. Exempt activities include the following activities: (1) projects for multifamily residential rental property; (2) sports facilities; (3) convention or trade show facilities; (4) airports, docks, wharves, mass commuting facilities,[6] parking facilities, or storage or training facilities directly related to these facilities; (5) sewage or solid waste disposal facilities, or facilities for the local furnishing of electricity or gas; (6) air or water pollution control facilities; (7) certain facilities for the furnishing of water; (8) qualified hydroelectric generating facilities;[7] and (9) local district heating or cooling facilities. In addition, interest on IDBs used to finance the acquisition or development of land as a site for an industrial park is exempt from tax.

The property that may be financed within each category of exempt-activity IDBs varies widely, both as to persons to be served by the facility and characteristics of the property itself. The scope of these exceptions may be illustrated by rules applicable to the following three exempt activities:

*Multifamily residential rental property.*—The rules governing projects for multifamily residential rental property illustrate both types of requirements that apply to exempt-activity IDBs. First, bond-financed multifamily residential rental property must be targeted to specified groups of tenants. This property must satisfy a

[4] A major portion is defined as more than 25 percent of the bond proceeds.

[5] *See*, II.C., below.

[6] Tax-exempt financing for mass commuting vehicles formerly was authorized under the exempt activity exception; that authorization expired for bonds issued after December 31, 1984.

[7] Generally, only costs of hydroelectric generating facilities attributable to periods before 1986 may be financed with tax-exempt bonds.

20-percent (15 percent in targeted areas) set-aside requirement for low -and moderate-income tenants and must remain as rental housing for the longer of the term of the IDBs or a statutorily prescribed minimum period. (The determination of low -or moderate-income is made by reference to the rules established under section 8 of the United States Housing Act of 1937, except that the base percentage of median gross income that qualifies as low or moderate is 80 percent.)

Second, the rules governing this multifamily residential rental property illustrate the application of property targeting rules. Bond-financed multifamily residential rental property includes property that is functionally related and subordinate to the housing units (as well as the units themselves). For example, swimming pools, tennis and racquet sports facilities, other athletic facilities, and parking garages for tenant use may be constructed with IDB proceeds. (Treas. Reg. sec. 1.103-8(b)(4).)

*Certain transportation property.*—Property financed pursuant to this exception includes both the specified type of property (e.g., airports, docks, wharves, and mass commuting facilities) and other related storage or training facilities. These related facilities must directly relate to the exempt activity and must be located on or adjacent to the exempt property for which the bonds are issued. In the case of airports, for example, a hotel located adjacent to the airport is a related facility, provided it is of a-size commensurate with the size of the airport. (Treas. Reg. sec. 1.103-8(e)(2)(D).) Similarly, a maintenance hangar for airplanes is a related structure, but office space or a computer serving a regional function of an airline company is not related property. (Treas. Reg. sec. 1.103-8(e)(2)(C).)

*Facilities for the local furnishing of electricity or gas.*—An investor-owned electric or gas utility may use tax-exempt IDB financing if the utility serves the general public in a service area that does not exceed two contiguous counties (or a city and one contiguous county). If this local furnishing requirement is satisfied, all property used in the production or transmission of electricity or gas may be financed with exempt-activity IDBs. Larger investor-owned utilities are not permitted to finance their property with tax-exempt bonds, other than pursuant to exceptions of more general application (e.g., air and water pollution control equipment).[8]

### *Small-issue IDBs*

Present law also permits tax-exemption for interest on small issues of IDBs, the proceeds of which are used for the acquisition, construction, or improvement of certain land or depreciable property used in privately owned and operated businesses (the small-issue exception).[9] The small-issue exception expires generally after December 31, 1986; small-issue IDBs to finance manufacturing facilities may be issued under the exception for an additional two years, through 1988.

[8] Governmentally owned and operated utilities may use tax-exempt financing under the general rules for borrowing for government operations, discussed above.

[9] The small-issue exception does not apply to obligations a significant portion of the proceeds of which are used to provide multifamily residential rental property. Thus, IDBs to finance residential rental property must be issued under the exempt-activity exception, discussed above.

Small-issue IDBs are issues having an aggregate authorized face amount (including certain outstanding prior issues) of $1 million or less. Alternatively, the aggregate face amount of the issue, together with the aggregate amount of related capital expenditures during the six-year period beginning three years before the date of the issue and ending three years after that date, may not exceed $10 million.[10]

In determining whether an issue meets the requirements of the small-issue exception, previous small issues (and in the case of the $10 million limitation, previous capital expenditures) are taken into account if (1) they are with respect to a facility located in the same incorporated municipality or the same county (but not in any incorporated municipality) as the facility being financed with the small-issue IDBs, and (2) the principal users of both facilities are the same, or two or more related, persons.

Capital expenditures are not considered if the expenditures (1) are made to replace property destroyed or damaged by fire, storm, or other casualty; (2) are required by a change in Federal, State, or local law made after the date of issue; (3) are required by circumstances that reasonably could not be foreseen on the date of issue;[11] or (4) are qualifying in-house research expenses (excluding research in the social sciences or humanities and research funded by outside grants or contracts).

*Mortgage subsidy bonds and mortgage credit certificates*

Mortgage subsidy bonds (MSBs) are bonds issued to finance the purchase or qualifying rehabilitation of single-family, owner-occupied homes located within the jurisdiction of the issuer of the bonds. Before 1980, no restrictions were placed on the issuance of these bonds. The Mortgage Subsidy Bond Tax Act of 1980 limited tax-exemption to two types of MSBs, qualified veterans' mortgage bonds and qualified mortgage bonds. Qualified veterans' mortgage bonds are general obligation bonds, the proceeds of which are used to make mortgage loans to veterans. Since 1984, these bonds may be issued only by States that had issued the bonds before June 22, 1984, and in amounts that reflect average annual issuance levels before that date.[12] Additionally, the Deficit Reduction Act of 1984 (the 1984 Act) provided for a gradual elimination of these bonds by restricting the veterans eligible for bond-financed loans to persons who served on active duty before 1977 and who apply for loans before the later of January 31, 1985,[13] or 30 years after leaving active service.

Qualified mortgage bonds are subject to the rules governing tax-exempt bonds generally and also to State volume limitations[14] and

[10] In the case of facilities with respect to which an Urban Development Action Grant (UDAG grant) is made under the Housing and Community Development Act of 1974, capital expenditures of up to $20 million are allowed.

[11] The excluded expenditures under this exception may not exceed $1 million.

[12] Sec. 611(c) of the Deficit Reduction Act of 1984 (P. L. 98-369). The States authorized to issue these bonds are Alaska, California, Oregon, Texas, and Wisconsin.

[13] Sec. 611(c) of the 1984 Act incorrectly provided that this date was January 1, 1985. H.R. 1800 and S. 814, the Technical Corrections Act of 1985, would correct this reference.

[14] These volume limitations are separate from the volume limitations for other private activity bonds (e.g., most IDBs, all student loan bonds, and qualified veterans' mortgage bonds).

other restrictions that apply only to these bonds. Authority to issue qualified mortgage bonds is scheduled to expire after December 31, 1987. At least 20 percent of the lendable proceeds of each issue must be made available for owner financing in targeted areas for a period of at least one year. Additionally, at least 90 percent of the lendable proceeds of each bond issue must be used to finance residences for first-time homebuyers (using a three-year test period) and the purchase price of the residences may not exceed certain prescribed amounts for each local area. Finally, qualified mortgage bonds are subject to additional arbitrage restrictions that require a rebate to the Federal Government of earnings in excess of specified amounts. Each of these requirements is discussed more fully in II.D. and II.F., below.

Issuers of qualified mortgage bonds may elect to exchange part or all of their authorized volume of these bonds and issue mortgage credit certificates (MCCs) in lieu of bonds. MCCs generally are subject to the same eligibility restrictions as qualified mortgage bonds. Authority to issue MCCs will expire with the underlying authority to issue qualified mortgage bonds. Taxpayers to whom MCCs are issued may claim a credit against their Federal income tax liability for a portion of the interest paid on their home mortgage.

### *Student loan bonds*

State and local governments may issue tax-exempt bonds to finance student loans. Subject to certain transitional exceptions, issuance of these bonds is permitted only in connection with loans guaranteed under the Guaranteed Student Loan (GSL) and Parent Loans for Undergraduate Students (PLUS) programs of the United States Department of Education.

The GSL and PLUS programs provide three direct Federal Government subsidies for qualified student loans. First, the Department of Education guarantees repayment of qualified student loans. Second, that Department pays special allowance payments (SAPs) as an interest subsidy on qualified student loans so that the student-borrowers will be charged lower interest rates on the loans. Third, the Education Department pays an additional interest subsidy on qualified loans while the student-borrowers attend school.

### *Tax-exempt bonds authorized by Federal statutes other than the Internal Revenue Code*

In addition to the Internal Revenue Code, several other Federal statutes have in the past authorized issuance of bonds on which the interest is tax-exempt. Examples of these "non-Code" bonds are housing bonds issued under section 11b of the United States Housing Act of 1937, and certain types of bonds issued by the District of Columbia and certain United States possessions (Puerto Rico, the Virgin Islands, American Samoa, and Guam).

Non-Code bonds were first made subject to the Code in 1983 with enactment of the Surface Transportation Assistance Act of 1982.[15] That Act provided that the tax-exemption for interest on non-Code

[15] P.L. 97-424.

bonds was derived from the Code, rather than from the other Federal statutes authorizing their issuance.

The Deficit Reduction Act of 1984 (the 1984 Act) first extended substantive Code restrictions to non-Code bonds.[16] The requirements extended to these bonds are (1) the Code rules relating to IDBs and MSBs, (2) the Code arbitrage restrictions, (3) the public approval and information reporting requirements applicable to private activity bonds; (4) the requirement that obligations be in registered form; (5) the disallowance of tax-exemption for obligations that are Federally guaranteed; (6) the overall State volume limitations applicable to most private activity bonds; and, (7) the private loan bond restriction.[17] The requirements applicable to a bond depend on the type of bond, i.e., the use of the proceeds. For example, the requirement that bonds be in registered form applies to all non-Code bonds, while the State volume limitations for most private activity bonds apply only if the non-Code bonds are IDBs subject to those limitations or are student loan bonds.

The 1984 Act also provided that future Federal tax-exemptions are available for bonds only when enacted as part of a revenue Act; this restriction applies to bonds issued after July 18, 1984.

[16] These restrictions apply generally to bonds issued after December 31, 1983; the restrictions apply to bonds issued under section 11b of the Housing Act of 1937 after June 18, 1984.

[17] H.R. 1800 and S. 814, the Technical Corrections Act of 1985, would clarify the application of the registered form requirement and the private loan bond restriction to these bonds.

## B. Qualified Issuers

Tax-exempt bonds must be issued by or on behalf of a qualified governmental unit. If the bonds are issued directly by a State, city, or county, compliance with this requirement is easily determined; however, bonds often are issued by other entities that are not clearly political subdivisions of a State. For example, private activity bonds such as IDBs frequently are issued by entities with limited sovereign powers (e.g., an industrial development commission). In such cases, the determination of whether the issuer is a political subdivision of the State may be less clear than in cases involving direct financings for local government operations. In general, an entity is a political subdivision (and thereby a qualified governmental unit) only if it has more than an insubstantial amount of one or more of the following governmental powers: the power to tax, the power of eminent domain, and the police power (in the law enforcement sense).

In addition to issuing bonds directly, a qualified governmental unit may establish other entities to issue bonds "on behalf of" the governmental unit. These on-behalf-of corporations developed historically because some State laws defined the purposes for which the State could issue bonds more narrowly than did Federal tax law. For example, qualified scholarship funding bonds are bonds issued by specially constituted nonprofit corporations acting on behalf of governmental units (sec. 103(e)). Similarly, a nonprofit corporation might own, operate, and issue debt to finance a local airport. The requirements that must be satisfied by these nonprofit corporations are specified in two administrative determinations of the Internal Revenue Service (Rev. Rul. 63-20, 1963-2 C.B. 397, and Rev. Proc. 82-26, 1982-1 C.B. 476). In general, these requirements are as follows:

(1) The corporation must engage in activities that are essentially public in nature;

(2) The corporation must not be organized for profit (except to the extent of retiring indebtedness);

(3) The corporate income must not inure to any private person;

(4) The State or a political subdivision thereof must have a beneficial interest in the nonprofit corporation while the indebtedness remains outstanding and must be able to obtain full legal title to the property of the corporation with respect to which the indebtedness was incurred by repaying the bonds; and

(5) The corporation must have been approved by the State or a political subdivision thereof, either of which also must have approved the specific obligations issued by the corporation. (Rev. Rul. 63-20, *supra.*)

## C. The Concept of Use

The *use* of bond proceeds and of bond-financed property is the basis for determining whether bonds are issued for general government operations or for a private activity, and thereby indirectly for determining the restrictions that must be satisfied if interest on the bonds is to be tax-exempt. Additionally, satisfaction of numerous requirements for tax-exempt IDBs is determined by reference to the concept of use.

The ultimate beneficiary of the tax-exempt financed property generally is treated as the user of the bond proceeds and of bond-financed property. A person may be a user of bond proceeds or a user of bond-financed property whether the use is direct or indirect. Under the Code rules, a person may be treated as a user of bond proceeds or bond-financed property as a result of (1) ownership or actual or beneficial use of the property pursuant to a lease, (2) a management contract, or (3) arrangements such as take-or-pay or output contracts.

### *Determination of type of bond*

Interest on bonds the proceeds of which are to be used by *nonexempt persons* is taxable unless an exception is provided in the Code for the type of activity to be financed. A nonexempt person is defined as any person other than a qualified governmental unit or a private charitable, scientific, religious, or educational organization (described in sec. 501(c)(3)). Thus, the United States (including its agencies and instrumentalities) and all private persons (other than organizations described in sec. 501(c)(3)) are nonexempt persons, and interest on bonds the proceeds of which are to be used by these persons is tax-exempt only when a specific exception is provided in the Code. On the other hand, interest on State or local government bonds the proceeds of which are used for general government operations or for private, nonprofit hospitals or universities and other charitable organizations (described in sec. 501(c)(3)) is tax-exempt under the general Code rule allowing issuance of tax-exempt obligations.

Bonds issued for use by nonexempt persons are divided into three major categories based upon *the use of the bond proceeds*—IDBs, MSBs, and student loan bonds. For example, present law defines IDBs as bonds all or a major portion of *the proceeds of which are to be used* in the trade or business of a nonexempt person and with respect to which a security interest test is satisfied. Interest on bonds issued for use by nonexempt persons that do not fall into any of these categories generally is taxable as interest on a private loan bond, discussed in II.A., above.

*Specific requirements based on the concept of use*

In addition to determining indirectly the restrictions that must be satisfied by an issue, the concept of use is important in applying various specific restrictions that must be satisfied by bonds for private activities as a condition of tax-exemption. For example, the following IDB restrictions require a determination of who is the user of tax-exempt bond proceeds or of bond-financed property:

*Ownership of IDBs by substantial users of bond-financed property prohibited.*—Interest on IDBs is not tax-exempt during any period when the bonds are owned by a person who is a *substantial user* [18] of the bond-financed property (sec. 103(b)(13)). Bonds owned by related parties to a substantial user are treated as owned by the user. This prohibition prevents a person from lending funds to himself or herself at tax-exempt interest rates, and receiving an income tax deduction for tax-exempt interest paid to himself or herself (or a related party).

*Public use requirement for exempt-activity IDBs.*—Tax-exempt IDBs may be issued for certain prescribed exempt activities (sec. 103(b)(4)). To qualify under this exception, the bond-financed property must be used for the prescribed exempt activity and must be available on a regular basis for general public use as opposed to being used exclusively by the persons in whose trade or business the property is used. For example, a dock serving a single manufacturer does not satisfy this public use requirement, but an airport hangar leased to a common carrier serving the general public does satisfy the requirement.

*Small-issue volume limitations.*—Tax-exempt small-issue IDBs must satisfy one of two special volume limitations, a $1 million "clean limit" restriction or an elective $10 million limitation. In determining whether the $1 million limitation is satisfied, outstanding prior issues are considered if (1) the bond-financed properties are located in the same municipality (or county, if not in any incorporated municipality), and (2) the *principal user* [19] of the properties will be the same person (or related person) (sec. 103(b)(6)(B)).

Under the elective $10 million limitation, all capital expenditures by principal users of the bond-financed property for any property located in the same municipality (or county, if not in any incorporated municipality) during a six-year period are aggregated (sec. 103(b)(6)(D) and (E)). Additionally, multiple issues of small-issue IDBs are aggregated in applying these volume limitations if the multiple issues are with respect to the same or related property, and principal users of any one or part of the properties are treated as such with respect to the entire property (or all of the related properties).

*Aggregate limit for small-issue IDBs.*—Interest on small-issue IDBs is not tax-exempt if the owner or any *principal user* of the bond-financed property during a three-year test period benefits from $40 million of outstanding IDBs (including both small-issue and exempt-activity IDBs).[20]

[18] A substantial user is a user of more than five percent of the bond-financed property.

[19] A principal user is a user of more than 10 percent of the bond-financed property.

[20] *See*, II.E., below.

## D. Restrictions Applicable to Tax-Exempt Bonds Generally

### *Private loan bond restriction*

Interest on private loan bonds [21] is not tax-exempt unless tax-exempt financing is authorized by the Code for the purpose for which bond proceeds are to be used (sec. 103(o)). Private loan bonds are obligations that are part of an issue of which five percent or more of the proceeds is to be used, directly or indirectly, to make or finance loans to persons other than exempt persons.[22] Although the proceeds of IDBs, MSBs, and qualified student loan bonds are used to make loans to nonexempt persons, these bonds are not subject to the restriction since tax-exemption is authorized specifically in the Code for all three of these types of bonds.[23]

An additional exception is provided for bonds issued to enable a borrower to finance any tax or governmental assessment of general application for an essential governmental function. For example, bonds to finance mandatory municipal water or sewer installation assessments that a local government generally permits residents to pay over a period of years are not treated as private loan bonds. On the other hand, bonds to finance loans that are available to the public generally, but that are not used to finance governmentally mandated activities, are taxable private loan bonds.

The private loan bond restriction applies whether bonds are used to finance loans for businesses or to finance personal loans. For example, an issue may be an issue of private loan bonds if five percent or more, but less than 25 percent, of the proceeds are used to make loans that would be considered IDB financing, but for the fact that bonds are not treated as IDBs if less than 25 percent of the proceeds is used to finance an activity satisfying the trade or business and security interest tests of the Code (sec. 103(b)(2)).

### *Arbitrage restrictions*

Interest on arbitrage bonds is taxable. All types of tax-exempt bonds are subject to one or more sets of restrictions on investment of bond proceeds, the violation of any one of which results in the bonds being arbitrage bonds. Under the first set of restrictions, if the proceeds of any otherwise tax-exempt bonds are reasonably expected to be invested at a yield that is materially higher than that of the bonds, the interest is taxable. Most IDBs are subject to additional arbitrage restrictions, that limit investment of the IDB proceeds in obligations that are unrelated to the purpose for which the

[21] The more descriptive term "private loan bonds" would be substituted for the present-law term consumer loan bonds by the Technical Corrections Act of 1985.

[22] The term exempt person includes qualified governmental units and certain charitable organizations. *See,* II.C., above.

[23] Certain specified private loan bond programs in existence when this restriction was enacted also are not subject to the requirement. *See,* sec. 626(b) of the 1984 Act.

IDBs are issued and that require a rebate to the Federal Government of excess earnings on the bonds. Qualified mortgage bonds also are subject to additional arbitrage restrictions that require that excess earnings be applied for benefit of the mortgagors or rebated to the Federal Government. Finally, the 1984 Act directed the Treasury Department, by regulations, to prescribe new arbitrage restrictions for qualified student loan bonds. These regulations will be effective no earlier than six months after their issuance.

The permissible arbitrage earnings under all of these restrictions depends on a comparison of the yield on the bonds and the yield on the investments acquired with the bonds. Various deductions are permitted that either increase the computed bond yield or decrease the computed yield on investments. For example, the Court of Appeals for the D.C. Circuit held in *State of Washington* v. *Commissioner*[24] that bond yield is the discount rate at which the present value of all anticipated payments of principal and interest on the bonds equals the net proceeds of the issue after deducting the costs of issuing the bonds. Because costs are deducted in determining net proceeds, there is a corresponding increase in the bond yield. Therefore, under the case, the bond issuer is permitted a higher yield on the investment of bond proceeds and may pay issuance costs out of arbitrage profits.

The method of determining bond yield provided by this case is used for the general arbitrage restrictions that apply to all tax-exempt bonds, but does not apply under the additional restrictions for IDBs or for qualified mortgage bonds. Under the additional IDB and qualified mortgage bond restrictions, the bond yield is based on the initial offering price to the public. The yield on the bonds is calculated without considering the present value of certain costs associated with the bonds that are considered under the general arbitrage restrictions. Thus, these costs may not be taken into account two times, thereby increasing permitted arbitrage profits.

### *Arbitrage restrictions applicable to all tax-exempt bonds*

*In general*

All tax-exempt bonds are subject to arbitrage restrictions limiting the investment of bond proceeds in investments whose yield is materially higher than that of the bonds. Exceptions are provided for materially higher yielding obligations that do not exceed a minor portion (15 percent) of the bond proceeds and for obligations held for a temporary period, both discussed below.

Treasury Department regulations provide rules for determining when an obligation has a yield that is materially higher than the bond yield. These regulations apply different arbitrage restrictions to "acquired purpose obligations" and "acquired nonpurpose obligations." Acquired purpose obligations are investments made to carry out the purpose of the bond issue. All other investments of bond proceeds are acquired nonpurpose obligations. Permissible arbitrage earnings generally are limited so the issuer may earn a spread between the yield on the bonds and the yield on acquired

[24] 692 F.2d 128 (D.C. Cir. 1982).

nonpurpose obligations not exceeding 0.125 percentage points plus reasonable administrative costs. Administrative costs basically are the costs of issuing, carrying, or redeeming the bonds, and the underwriter's discount.

There are two principal exceptions to this restriction. First, unlimited arbitrage is permitted on proceeds invested for a temporary period prior to use, whether by the issuer or the user of bond proceeds. This temporary period generally may not exceed three years from the date of issue. An issuer may waive the temporary period and receive an arbitrage spread of 0.5 percentage points plus allowable costs (instead of 0.125 percentage points) with respect to the bonds. Second, unlimited arbitrage is permitted on investments held in a reasonably required reserve or replacement fund. All amounts held in a reserve fund are applied against the 15-percent minor portion that may be invested without regard to yield restrictions. Since an issue may not be deliberately increased to take advantage of the minor portion rule, reserve funds are the most important example of a minor portion.

*Increased yield permitted for certain governmental programs*

In the case of student loan bonds and other obligations issued in connection with certain governmental programs, permissible arbitrage earnings on investments acquired in connection with the program ("acquired program obligations") are restricted to the difference between the interest on the bonds and the interest on the acquired program obligations, but not exceeding the greater of (1) 1.5 percentage points plus reasonable administrative costs or (2) all reasonable direct costs of the loan program (including issuance costs and bad debt losses). SAP payments made by the Department of Education are not taken into account in determining yield on student loan bonds, and thereby the amount of arbitrage profits earned with respect to the bonds.

### *Additional arbitrage restrictions for most IDBs*

*Rebate requirement*

IDBs other than IDBs for multifamily residential rental property are subject to additional arbitrage restrictions.[25] Under these additional restrictions, certain arbitrage profits earned on nonpurpose obligations acquired with the gross proceeds of the IDBs must be rebated to the Federal Government. No rebate is required if all gross proceeds of an issue are expended within six months of the issue date and for the purpose for which the bonds are issued. Additionally, if less than $100,000 is earned on a bona fide debt service fund with respect to an issue in a bond year, arbitrage earned on the fund in that year is not subject to the rebate requirement, unless the issuer elects to consider those earnings when determining if a rebate otherwise is due with respect to the bonds.

For purposes of these additional IDB restrictions, nonpurpose obligations generally include all investments other than those specifi-

[25] Housing bonds issued under section 11b of the Housing Act of 1937 that are IDBs also are exempt from these additional restrictions.

cally made to carry out the purpose for which the IDBs are issued. Gross proceeds include both the original proceeds of the borrowing, the return on investments of the bond proceeds, and amounts used or available to pay debt service on the bonds. Arbitrage profits that must be rebated include both income earned on investment of the bond proceeds and earnings on that income. Ninety percent of the rebate required with respect to any issue must be paid at least once each five years, with the balance being paid within 30 days after retirement of the bonds.

*Limitation on investment in nonpurpose obligations*

In addition to the rebate requirement, the amount of IDB proceeds that may be invested in nonpurpose obligations at a yield above the bond yield generally is restricted to 150 percent of the debt service. This limitation does not apply to amounts invested for certain initial temporary periods or to amounts held in a bona fide debt service fund. Debt service includes interest and amortization of principal scheduled to be paid with respect to an issue for the bond year, but does not include payments with respect to bonds that are retired before the beginning of the bond year.

### *Additional arbitrage restrictions applicable to qualified mortgage bonds*

Additional arbitrage restrictions also are imposed on qualified mortgage bonds.[26] These restrictions apply both to arbitrage earnings on mortgage investments and on nonmortgage investments.

*Mortgage investments*

The effective rate of interest on mortgage loans provided with an issue of qualified mortgage bonds may not exceed the yield on the issue by more than 1.125 percentage points. This determination is made on a composite basis for all mortgage loans made from the proceeds of the issue. Consequently, the effective interest rate on some mortgage loans is permitted to be greater than 1.125 percentage points above the yield of the issue, if other mortgages have a lower effective interest rate.

*Nonmortgage investments*

The amount of qualified mortgage bond proceeds that may be invested at an unrestricted yield in nonmortgage investments is limited to 150 percent of the debt service on the issue for the year. Exceptions to the 150-percent of debt service rule are provided for proceeds invested for an initial temporary period until the proceeds are needed for mortgage loans or for temporary debt service funds. Arbitrage earned on nonmortgage investments must be paid or credited to the mortgagors or paid to the Federal Government.

[26] Qualified veterans' mortgage bonds are not subject to any additional arbitrage restrictions beyond the restrictions imposed on tax-exempt bonds generally.

### *Prohibition on Federal guarantees of tax-exempt bonds*

In general, tax-exemption is not permitted for interest on any bond that is Federally guaranteed. A bond is treated as Federally guaranteed if (1) the payment of principal or interest is directly or indirectly guaranteed, in whole or in part, by the United States;[27] (2) a significant portion (5 percent or more) of the proceeds of the issue of which the bond is a part is to be used in making loans or other investments the payments on which are guaranteed in whole or in part by the United States; (3) a significant portion of the proceeds of the issue is to be invested in Federally insured deposits or accounts in a financial institution; or (4) the payment of the principal of or interest on the obligation is otherwise indirectly guaranteed, in whole or in part, by the United States. For purposes of this prohibition, an entity with Federal statutory authority to borrow from the United States is treated as an instrumentality of the United States, and a guarantee of bonds by the entity results in the denial of tax-exemption.

Tax-exemption is denied under this prohibition in any case where the substance of a transaction, as opposed to its form, results in the United States being the party ultimately responsible for repayment of the bonds. A number of exceptions are provided, however, under which Federal programs in existence at the time the prohibition was enacted are permitted to continue to provide Federal guarantees of tax-exempt bonds. For example, guarantees provided under the GSL program of the Department of Education or by the Student Loan Marketing Association (SLMA) are permitted as are guarantees by the Federal Housing Administration (FHA), the Veterans' Administration (VA), the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC), and the Government National Mortgage Association (GNMA). Additionally, guarantees by the Small Business Administration with respect to qualified contracts for pollution control facilities are permitted in certain cases.

### *Registered form requirement*

Tax-exempt bonds must be issued in registered form. This requirement is satisfied if the bonds are issued so as to require surrender of the old bond and either (1) reissuance by the issuer to the transferee, or (2) issuance of a new bond. Additionally, book-entry registration systems are permitted if the right to payment of the bond principal and interest is transferable only through a book entry that satisfies the requirements of Treasury Department regulations.

### *Information reporting requirements*

Issuers of IDBs, student loan bonds, bonds for charitable and educational institutions (described in sec. 501(c)(3)), and MSBs must report certain information to the Internal Revenue Service about bonds issued by them during each preceding calendar quarter. This report is due on the 15th day of the second month after the close of

[27] For purposes of this prohibition, the term United States includes all agencies and instrumentalities thereof.

the calendar quarter in which the bonds are issued. Interest is taxable on bonds with respect to which the required report is not made.

The reports for bonds other than MSBs must include the following information with respect to each bond issue:

(1) The date of the issue, the stated interest rate, the term, the face amount of each bond that is part of the issue, and the amount of lendable proceeds of the issue;

(2) In the case of IDBs, the name of the elected official or legislative body that approved the issue;[28]

(3) The name, address, and tax identification number of each initial principal user of any property financed with the bond proceeds, and of certain related parties to the principal users; and

(4) A description of the property financed with the bond proceeds.

Similar information must be reported for each issue of mortgage subsidy bonds.

[28] *See,* II.E., below, for a discussion of the public approval requirements that apply to IDBs.

## E. Additional Requirements for Private Activity Bonds (Other than Mortgage Subsidy [illegible]

### *State volume limitations*

#### *General rules*

The amount of private activity bonds [illegible] State, and other qualified issuers within the State, may issue during any calendar year is limited to the greater of $150 for each resident of the State[29] or $200 million.[30] Private activity bonds subject to these State volume limitations include most IDBs and all student loan bonds. The $150 per capita limitation continues until 1987, at which time it is scheduled to be reduced to $100 to reflect the termination of the small-issue exception for other than manufacturing facilities.[31]

Each State's volume limitation for private activity bonds is allocated one-half to State issuers and one-half to localities within the State on the basis of relative populations, unless the State adopts a statute providing for a different allocation. There also was an interim provision allowing the Governor of any State to adopt an allocation formula by gubernatorial proclamation. A public official responsible for allocating volume limitation must certify, under penalty of perjury, that each allocation is not made in consideration of any bribe, gift, gratuity, or direct or indirect contribution to any political campaign.

An issuer's volume authority generally must be used for bonds issued in the calendar year for which it is allocated. An issuer may elect, however, to carry forward unused bond authority for up to three years for specific, identified projects, or for the general purpose of issuing student loan bonds. This carryforward period is extended to six years in the case of pollution control projects (described in sec. 103(b)(4)(F)). Carryforward allocations may not be made for small-issue IDBs.

#### *Exceptions*

IDBs to finance projects for multifamily residential rental property (sec. 103(b)(4)(A)) are not subject to the State volume limitations. This exception includes public housing program obligations issued under section 11(b) of the United States Housing Act of 1937 that are IDBs. In addition to these bonds for rental housing, the volume limitations do not apply to certain IDBs the proceeds of which are used to finance convention or trade show facilities, air-

[29] The population of each State is based on the most recent estimate of the Bureau of the Census.

[30] The District of Columbia is treated as a State. U.S. possessions (e.g., Puerto Rico, the Virgin Islands, Guam, and American Samoa) are subject to a limitation of $150 per resident of the possession.

[31] The $200 million minimum State volume limitation is not scheduled to be reduced.

ports, docks, wharves, or mass commuting facilities (described in sec. 103(b)(4)(C) and (D)). IDBs for these latter facilities are exempt from the volume limitations, however, only if the property financed with the IDBs is owned for Federal tax purposes by, or on behalf of, a qualified governmental unit. The exception from the volume limitations does not apply to parking facilities financed with IDBs (even though described in sec. 103(b)(4)(D)) unless the parking facilities also are governmentally owned and are functionally related and subordinate to other property that qualifies under the exception (e.g., an airport parking lot).

Bonds issued to refund other private activity bonds also are not subject to the State volume limitations, provided that the amount of the refunding bonds does not exceed the outstanding principal amount of the refunded obligations. In the case of student loan bonds, refunding bonds are not subject to the limitation only if, in addition to the rule above, the maturity date of the refunding bonds do not exceed the later of (1) the maturity date of the refunded obligation, or (2) the date that is 17 years after the date on which the original obligation was issued.

*Public approval requirement*

For interest on IDBs to be tax-exempt, a public hearing must be held, and the issuance of the bonds must be approved by an elected public official or elected legislative body. As an alternative to these requirements, issuance of the IDBs may be approved by a voter referendum. These restrictions apply to all IDBs, including IDBs exempt from the State volume limitations; however, they do not apply to student loan bonds or to other non-IDB tax-exempt bonds.

If the bond-financed property is located outside of the issuing jurisdiction, the public approval requirement generally must be satisfied by the issuing jurisdiction and all other jurisdictions in which the bond-financed property (or parts thereof) will be located.[32] The public approval requirement is satisfied, however, if one governmental unit, having jurisdiction over all the property being financed, holds a hearing and approves issuance of the bonds (e.g., a hearing held at the State level followed by governor's approval of the issue).

*Restrictions on acquisition of land and existing property*

*Nonagricultural land*

Interest on IDBs is taxable if more than 25 percent of the proceeds of the issue of which the IDBs are a part is used to finance the acquisition of any interest in nonagricultural land. This restriction applies both to exempt-activity and to small-issue IDBs. The 25-percent restriction is increased to 50 percent in the case of IDBs issued to finance an industrial park (described in sec. 103(b)(5)). An additional exception to the land acquisition rules is provided for certain land acquired by a public agency in connection with an airport, mass transit, or port development project (described in sec.

[32] In the case of governmentally owned airports located outside of the boundaries of an issuing authority that also owns the airport, only the issuer/owner is required to satisfy the public approval requirement.

103(b)(4)(D)) for a noise abatement, wetland preservation, future use, or other public use, but only if there is no other significant use of the land before the expansion occurs.

### *Agricultural land*

Agricultural land may be financed with IDBs without regard to the general 25-percent limitation on the use of IDBs to finance land, discussed above, if two conditions are satisfied.[33] First, this exception is limited to loans to first-time farmers, and second, each first-time farmer is limited to a maximum of $250,000 of IDB-financing. A first-time farmer is an individual who has not at any time had any direct or indirect ownership in substantial farmland in the operation of which the individual or the individual's spouse or dependent children have materially participated. Substantial farmland for this purpose includes any parcel of land (1) that is greater than 15 percent of the median size of a farm in the county in which the land is located, or (2) the fair market value of which exceeds $125,000 at any time when the land is held by the individual in question.

A *de minimis* portion of IDB financing provided under this exception may be used for the acquisition of used farming equipment (without regard to the restriction on financing existing property, discussed below). Only equipment acquired within one year after acquisition of the farmland is eligible for tax-exempt financing under this exception.

### *Existing property*

Tax-exempt IDBs generally may not be used to finance the acquisition of previously used property. As with the restriction on the acquisition of land, this restriction applies both to exempt-activity and small-issue IDBs. An exception is provided, however, permitting the acquisition of an existing building (and equipment for such a building) if expenditures for rehabilitation of the building and equipment exceed 15 percent of the lesser of (1) the purchase price of the building and related equipment, or (2) the amount of bonds issued for acquisition of the building and related equipment. For example, if IDBs are used to purchase a building for $500,000, and existing equipment in the building for $250,000, interest on the bonds would be tax-exempt if rehabilitation expenditures of at least $112,500 (i.e., 15 percent of $750,000) were made. A parallel exception also applies to nonbuilding structures (e.g., dry docks), but in such cases, the rehabilitation expenditures must exceed 100 percent of the lesser of the cost or the bond-financing.

Qualified rehabilitation expenditures generally include any amount chargeable to capital account that is incurred in connection with the rehabilitation project. Only expenditures incurred before the date that is two years after the date the building is acquired, or (if later) the date the bonds are issued, are qualified rehabilitation expenditures. In the case of an integrated operation contained in a building before its acquisition, rehabilitation expenditures also include the expenses of rehabilitating existing

[33] Agricultural land is eligible for financing only under the small-issue exception.

equipment previously used to perform the same function in the building, or replacing the existing equipment with equipment having substantially the same function.

*Restrictions on financing certain specified property*

In addition to the general restrictions imposed on IDB-financing for land and existing property, additional restrictions are imposed with respect to certain specified property. First, interest on IDBs (both exempt-activity and small-issue IDBs) is taxable if any portion of the bond proceeds is used to finance any airplane, any skybox or other private luxury box, any health club facility, any facility primarily used for gambling, or any store the principal business of which is the sale of alcoholic beverages for off-premises consumption.

Second, interest on small-issue IDBs is not tax-exempt if (1) more than 25 percent of the proceeds of the issue is used to provide a facility the primary purpose of which is retail food and beverage services (including all eating and drinking establishments but not grocery stores), automobile sales or service, or the provision of recreation or entertainment, or (2) any portion of the proceeds is used to provide any private or commercial golf course, country club, massage parlor, tennis club, skating facility, racquet sports facility, hot tub or sun tan facility, or racetrack.

*Restriction on maturity of IDBs*

The average maturity of all IDBs may not exceed 120 percent of the economic life of the property to be financed. For example, if the proceeds of an issue of IDBs are used to purchase assets with an average estimated economic life of 10 years, the average maturity for the bonds may not exceed 12 years. The economic life of a facility is measured from the later of the date the bonds are issued or the date the assets are placed in service.

For purposes of this restriction, the economic life of facilities is determined on a case-by-case basis. However, the legislative history of the restriction states that, in order to provide guidance and certainty, the administrative guidelines used to determine useful lives for depreciation purposes before enactment of the ACRS system (i.e., ADR midpoint lives and the guideline lives under Rev. Proc. 62-21, 1962-2 C.B. 418, in the case of structures) may be used to establish the economic lives of assets.[34]

*$40 million limitation with respect to small-issue IDBs*

Interest on small-issue IDBs is taxable if the aggregate face amount of all outstanding tax-exempt IDBs (both exempt-activity and small-issue) that would be allocated to any beneficiary of the IDBs exceeds $40 million. To avoid double counting, bonds that are to be redeemed with the proceeds of a new issue are not considered.

The face amount of any issue is allocated among persons who are owners or principal users of the bond-financed property during a three-year test period. This may result in all or part of a facility being allocated to more than one person, as when one person owns

[34] *See*, H. Rpt. No. 97-760, 97th Cong., 2d Sess. (August 17, 1982), p. 519.

bond-financed property and other persons are principal users, or when owners and/or principal users change during the three-year test period.[35] Once an allocation to a test-period beneficiary is made, that allocation remains in effect as long as the bonds are outstanding, even if the beneficiary no longer owns or uses the bond-financed property.

*Advance refundings prohibited*

In the case of IDBs and mortgage subsidy bonds,[36] interest on refunding bonds is tax-exempt only if the refunding bonds are issued no more than 180 days before the refunded issue is redeemed (i.e., the refunded and the refunding issues may not be outstanding simultaneously for more than 180 days). Interest on refunding bonds that are outstanding for more than 180 days before refunded IDBs or mortgage subsidy bonds are redeemed (advance refunding bonds) does not qualify for tax-exemption. Advance refundings are permitted in the case of bonds used by exempt entities (e.g., for general government operations or by charitable organizations described in sec. 501(c)(3)).

A refunding issue generally is considered to be used for the same purposes as the issue being refunded. For example, if the refunded issue was used for an exempt activity under the rules applicable to IDBs, the refunding obligation generally is also considered to be so used. A refunding issue is an issue used to pay principal, interest, or call premium on a prior issue, together with reasonable incidental costs of the refunding. An issue is not treated as a refunding issue for purposes of the restriction on advance refunding if the prior issue had a term of less than 3 years (including the term of any prior refunded notes) and was sold in anticipation of permanent financing. (Prop. Treas. Reg. sec. 1.103-7(e).)

[35] If the $40 million limit is exceeded for any owner or principal user as a result of a change during the test period, interest on the issue of IDBs that cause the limit to be exceeded is taxable from the date of issue. The tax-exempt status of interest on other, previously issued, IDBs is not affected.

[36] This provision applies to both qualified mortgage bonds and qualified veterans' mortgage bonds. (*See*, II.F., below.)

## F. Additional Requirements for Mortgage Subsidy Bonds

### *Qualified veterans' mortgage bonds*

As stated in II.A. above, tax-exemption is allowed for two types of mortgage subsidy bonds—qualified veterans' mortgage bonds and qualified mortgage bonds.

#### *General rules*

Qualified veterans' mortgage bonds are general obligation bonds the proceeds of which are used to make mortgage loans to veterans. These bonds are subject to various limitations that will lead to an eventual phase-out of the programs. Authority to issue qualified veterans' mortgage bonds is limited to States that had issued such bonds before June 22, 1984. The States qualifying under this restriction are Alaska, California, Oregon, Texas, and Wisconsin. Additionally, loans financed with qualified veterans' mortgage bonds may be made only with respect to principal residences.

#### *State volume limitations*

The annual volume of qualified veterans' mortgage bonds that qualifying States may issue is limited according to a formula based on the aggregate volume of such bonds issued by qualified issuers within the State during the period beginning on January 1, 1979, and ending on June 22, 1984. Under the formula, the aggregate amount of these bonds is divided by the number of years (not exceeding five) during which such bonds were issued.[37]

#### *Loans may be made only to qualified veterans*

Mortgage loans made with the proceeds of qualified veterans' mortgage bonds may be made only to veterans who served on active duty before 1977, and who apply for the loan before the later of (1) 30 years after the veteran leaves active service, or (2) January 31, 1985.[38]

### *Qualified mortgage bonds*

In addition to the rules applicable to all tax-exempt bonds, qualified mortgage bonds are subject to various restrictions, including separate State volume limitations; borrower eligibility and targeting rules; special arbitrage restrictions; a prohibition on advance

[37] For purposes of these volume limitations, certain short-term notes to finance property taxes on residences financed with qualified veterans' mortgage bond loans are counted at one-fifteenth of their principal amount. Additionally, bonds issued in the year of lowest issuance from 1979 through June 22, 1984, are not counted.

[38] Sec. 611(c) of the 1984 Act incorrectly provided that this date was January 1, 1985. H.R. 1800 and S. 814, the Technical Corrections Act of 1985, would correct this reference.

refunding; information reporting requirements; and an annual policy statement requirement.[39]

### *Volume limitations*

The aggregate annual volume of qualified mortgage bonds that a State, and local governments within the State, are permitted to issue is limited to the greater of (1) nine percent of the average annual aggregate principal amount of mortgages executed during the three preceding years for single-family, owner-occupied residences located within the State, or (2) $200 million. Each State's volume limitation is allocated 50 percent to State and 50 percent to local issuers (on the basis of mortgage activity), unless the State enacts a statute providing for a different allocation.

### *Eligibility requirements*

#### *Limitation to single-family, owner-occupied residences*

All lendable proceeds (i.e., total proceeds less issuance costs and reasonably required reserves) of qualified mortgage bonds must be used to finance the purchase or rehabilitation of single-family residences located within the jurisdiction of the issuing authority. Additionally, it must reasonably be expected that each residence will become the principal residence of the mortgagor within a reasonable time after the financing is provided. The term single-family residence includes two-, three-, and four-family residences if (1) the units in the residence are first occupied at least five years before the mortgage is executed, and (2) one unit in the residence is occupied by the owner of the units.

Tenant-stockholders of cooperative housing corporations (sec. 216) may qualify for qualified mortgage bond financing under certain conditions.

#### *General limitation to new mortgages*

With certain exceptions, all lendable proceeds of qualified mortgage bonds must be used for acquisition of new, rather than existing, mortgages. The exceptions permit replacement of construction period loans and other temporary initial financing, and certain rehabilitation loans. Assumptions of loans financed with qualified mortgage bond proceeds are permitted if the residence satisfies the location and principal residence requirements, discussed above, and the assuming mortgagor satisfies the three-year and purchase price requirements, discussed below.

#### *Three-year requirement ("first-time homebuyer" rule)*

In order for an issue to be a qualified mortgage bond issue, at least 90 percent of the lendable proceeds must be used to finance residences for mortgagors who have had no present ownership interest in a principal residence at any time during the three-year period ending on the date the mortgage loan is executed. The three-year requirement does not apply with respect to mortgagors

[39] *See*, II.D., above, for a discussion of the arbitrage restrictions and information reporting requirements that apply to qualified-mortgage bonds, and II.E. for a discussion of the prohibition on advance refunding of these bonds.

in three situations: (1) mortgagors of residences that are located in targeted areas; (2) mortgagors who receive qualified home improvement loans; and (3) mortgagors who receive qualified rehabilitation loans.

*Purchase price restrictions*

All mortgage loans provided from the bond proceeds (except qualified home improvement loans) must be for the purchase of residences the acquisition cost of which does not exceed 110 percent of the average area purchase price applicable to that residence. This limit is increased to 120 percent of the average area purchase price in targeted areas (described below). The determination of average area purchase price is made separately (1) with respect to new and previously occupied residences, and (2) with respect to one-, two-, three-, and four-family residences.

*Targeted area requirement*

At least 20 percent of the lendable proceeds of each qualified mortgage bond issue (but not more than 40 percent of the average mortgage activity in the targeted area) must be made available for owner-financing in targeted areas for a period of at least one year. The term targeted area is defined as (1) a census tract in which 70 percent or more of the resident families have income that is 80 percent or less of the Statewide median family income, or (2) an area designated as an area of chronic economic distress using statutorily defined criteria (described in sec. 103A(k)(3)).

*Annual policy statement*

Issuers of qualified mortgage bonds and MCCs must publish and submit to the Treasury Department an annual report detailing the policies that the jurisdiction intends to follow in the succeeding year with respect to these programs. This report must be published and submitted before the last day of the year preceding each year in which any such bonds are issued. A public hearing must be held before publication and submission of the report.

***Mortgage credit certificate (MCC) alternative to qualified mortgage bonds***

State and local governments may elect to exchange all or any portion of their qualified mortgage bond authority for authority to issue mortgage credit certificates (MCCs). MCCs entitle homebuyers to nonrefundable income tax credits for a specified percentage of interest paid on mortgage loans on their principal residences. Once issued, an MCC remains in effect as long as the residence being financed continues to be the credit-recipient's principal residence. Credit amounts that may not be used in any year (because the credit is nonrefundable) may be carried forward for up to three years. MCCs generally are subject to the same eligibility and targeted area requirements as qualified mortgage bonds.

Each MCC must represent a credit for at least 10 percent (but not more than 50 percent) of interest on qualifying mortgage indebtedness. The actual dollar amount of an MCC depends on the amount of qualifying interest paid during any particular year. If the credit percentage exceeds 20 percent, however, the dollar amount of the credit received by the taxpayer for any year may not exceed $2,000.[40] Thus, only individuals who purchase lower-priced residences may benefit from a credit rate in excess of 20 percent.

The aggregate amount of MCCs distributed by an electing issuer may not exceed 20 percent of the volume of qualified mortgage bond authority exchanged by the State or local government for authority to issue MCCs. For example, a State that is authorized to issue $200 million of qualified mortgage bonds, and that elects to exchange $100 million of that bond authority, may distribute an aggregate amount of MCCs equal to $20 million.

When a homebuyer receives an MCC, the homebuyer's deduction for interest on the qualifying indebtedness (under sec. 163(a)) is reduced by the amount of the credit. For example, a homebuyer receiving a 50-percent credit, and making $4,000 of mortgage interest payments in a given year, would receive a $2,000 credit and a deduction for the remaining $2,000 of interest payments.

The authority to issue mortgage credit certificates terminates on December 31, 1987, together with the authority to issue qualified mortgage bonds.

[40] In States whose volume limitation for qualified mortgage bonds exceeds 20 percent of the average mortgage originations and that issued fewer than $150 million of qualified mortgage bonds in 1983, the weighted average percentage of MCCs may not exceed 20 percent.

# III. OTHER PROVISIONS AFFECTING THE TAX TREATMENT OF STATE AND LOCAL GOVERNMENT BONDS

In addition to the general tax-exemption provided for interest on State and local government bonds, other provisions affect the Federal subsidy available to owners and other beneficiaries of these bonds.

## A. Cost Recovery Deductions for Property Used in a Trade or Business or for the Production of Income

The cost of property that is used in a trade or business, or otherwise for the production of income, and that has a useful life of more than one year may be recovered through tax deductions (sec. 168). The present-law Accelerated Cost Recovery System (ACRS) prescribes recovery periods of from 3 years (automobiles) to 18 years (real property).[41] These recovery periods generally are shorter than the economic life of the property. In addition, the ACRS system prescribes a cost recovery method that further accelerates cost recovery by permitting larger deductions in the early years of the recovery period. For personal property, this cost recovery method approximates the effect of using a 150 percent declining balance method in the initial years followed by the straight-line method in years when the declining balance method would produce smaller deductions. For real property, the ACRS method for the initial years is the equivalent of a 175 percent declining balance method.[42]

The cost of property financed with tax-exempt bonds is eligible for recovery over the prescribed ACRS periods, but generally is not eligible for the accelerated cost recovcry methods provided by ACRS (sec. 168(f)(12)). Projects for multifamily residential rental property (sec. 103(b)(4)(A)) are not subject to this restriction, and therefore may qualify for both tax-exempt financing and accelerated ACRS deductions.[43]

## B. Investment Tax Credit

A tax credit is permitted with respect to investment in certain types of property (sec. 38). The amount of this credit ranges from six percent of qualified investment expenditures for automobiles to

[41] Taxpayers may elect extended recovery periods of up to 45 years (sec. 168(b)(3)). Additionally, in the case of certain property leased to governments and other tax-exempt entities, extended recovery periods are required under the present-law ACRS system (sec. 168(j)).

[42] Certain low-income housing is permitted a 200 percent declining balance method (as well as a shorter recovery period than real property generally) (secs. 168(c)(4) and 1250(a)(1)(B)).

[43] This cost recovery restriction originally was enacted by the Tax Equity and Fiscal Responsibility Act of 1982, and included exceptions for multifamily residential rental property, certain public sewage or solid waste facilities, certain air or water pollution control facilities, and property with respect to which an Urban Development Action Grant (UDAG) was made. The exceptions for bond-financed property other than multifamily residential rental property were repealed in 1984.

25 percent of such expenditures for rehabilitation of certified historic structures. An adjustment to the basis of property equal to one-half of the credit claimed generally is required.[44] Property that is financed with tax-exempt bonds generally is eligible for the investment credit on the same basis as property financed with taxable debt. However, a special rule requires taxpayers to elect between the rehabilitation tax credit and tax-exempt financing in the case of certain property leased to governments or other tax-exempt entities (i.e., tax-exempt use property).

### C. Deductibility of Expenses Related to Tax-Exempt Income

Taxpayers are not permitted to deduct interest expense incurred or continued to purchase or carry tax-exempt obligations (sec. 265(2)). This rule applies both to individual and corporate taxpayers. The rule also applies to certain cases in which a taxpayer incurs or continues interest expense and a related person acquires or holds tax-exempt obligations.[45]

The courts and the Internal Revenue Service have interpreted the section 265(2) rule to disallow an interest deduction only when a taxpayer incurs or continues indebtedness for the purpose of acquiring or holding tax-exempt obligations. Because banks are not considered to accept deposits for the purpose of acquiring tax-exempt obligations, the disallowance rule generally has not been applied to them. In other cases, the rule has been applied on a case-by-case basis. *See,* e.g., Rev. Proc. 72-18, 1972-1 C.B. 740; *Wisconsin Cheeseman, Inc.* v. *United States,* 388 F.2d 420 (7th Cir. 1968). Under a related provision, however, the amount of the otherwise allowable deduction for interest allocable to tax-exempt obligations is reduced by 20 percent under rules on preference items for banks.[46]

### D. Income Tax Treatment of Social Security Benefits

The amount of tax-exempt interest received by an individual can affect the extent to which he or she is taxable with respect to social security benefits received (sec. 86). In general, up to one-half of such benefits are taxable to the extent that the taxpayer's modified adjusted gross income, when added to the amount of the benefits, exceeds a base amount. The base amount is $32,000 in the case of a joint return, zero in the case of married taxpayers who do not live separately for the entire year but who file separate returns, and $25,000 for all other taxpayers.

Modified adjusted gross income is calculated by adding to adjusted gross income certain items that otherwise are excludable. Tax-exempt interest is among these items. If the sum of modified adjusted gross income and one-half of social security benefits received exceeds the base amount, then the taxpayer's adjusted gross

[44] In the case of the 15 -and 20-percent rehabilitation credits, this basis adjustment is equal to the full amount of the credit.

[45] In addition to interest deductions, present law (sec. 265(1)) denies a deduction for nonbusiness expenses for the production of tax-exempt interest income, which expenses would otherwise be deductible under section 212 of the Code. This may include, for example, brokerage and other fees associated with a tax-exempt portfolio. Present law also disallows deductions for certain expenses of tax-exempt mutual funds and for interest to purchase or carry shares in such a fund.

[46] *See,* II.E., below.

income is increased by the lesser of (1) one-half of this excess, or (2) one-half of the social security benefits received. Under this provision, tax-exempt interest may cause a taxpayer's adjusted gross income to be greater, by as much as one-half of the amount of the social security benefits received, than it would have been had he or she not received any tax-exempt interest.

## E. Minimum Tax and Preference Reduction Provisions

Minimum taxes are imposed, respectively, on individuals and on corporations (secs. 55-58). In general, minimum taxes are designed to ensure that taxpayers with substantial economic income pay tax equaling at least a specified percentage of that income. To accomplish this goal, the minimum tax provisions require that certain tax preferences[47] be regarded as income for minimum tax purposes.

Individuals are subject to an alternative minimum tax, imposed at a 20-percent rate (above an exemption amount) on an income base derived by adding certain preferences to taxable income and by denying certain itemized deductions. The tax is payable to the extent that it exceeds the taxpayer's regular tax liability. Corporations are subject to an add-on minimum tax, imposed at a 15-percent rate on a base derived by adding together certain preferences (but without adding them to taxable income) and then subtracting the amount of regular tax paid.

Tax-exempt interest presently is not treated as a preference for minimum tax purposes. However, tax-exempt interest is relevant under a related provision that restricts the use of certain preference items for regular tax purposes (sec. 291). In general, this related provision requires reductions (typically, 15 or 20 percent) in the amount by which the regular tax treatment of a particular item is more favorable than it would be under a rule that is deemed more economically accurate, or that applies to a more general category of items.

Among the items with respect to which a reduction must be made is interest on debt incurred by banks.[48] to purchase or carry tax-exempt obligations acquired after 1982.[49] The determination of what interest was incurred to purchase or carry tax-exempt obligations is made through allocation on a percentage-of-assets basis. Specifically, a bank that is subject to this restriction first must calculate the percentage of average adjusted basis for its assets that it derives from tax-exempt obligations acquired in 1983 or thereafter. It then must treat the same percentage of its total interest deductions that otherwise are allowable as having been incurred to purchase or carry the obligations. A deduction is disallowed for 20 percent of the interest so allocated to the purchase and carrying cost of the tax-exempt obligations.

[47] In general, a tax preference may be defined as an incentive provision that causes the taxable income of benefited taxpayers to be less than their economic income.

[48] A bank in this context is defined as (1) any institution that is incorporated as a bank in the United States, any State, or the District of Columbia, and (2) any nonprofit mutual savings bank, domestic building and loan association, or cooperative bank without capital stock.

[49] *See*, III.C., above, for a discussion of the general rule governing deductibility of expenses related to tax-exempt income.

## F. Gift, Estate, and Generation-Skipping Transfer Tax Treatment of State and Local Government Bonds

The value of State and local government obligations is subject to Federal gift, estate, or generation-skipping transfer tax if the obligations are transferred by gift or as a result of death.[50] Additionally, present law provides that an exemption from these taxes arises only if the Federal statute under which the tax-exemption is granted specifically refers to the appropriate provisions of the Internal Revenue Code that impose those taxes. Therefore, any general grant of tax-exemption applies only to the income tax. Any tax-exemption provided by laws enacted before 1984 applies to Federal gift, estate, or generation-skipping transfer taxes only if those tax-exemptions specifically refer to these taxes (even if not to the actual Code provisions under which the taxes are imposed).

[50] In *Haffner* v. *U.S.*, the Court of Appeals for the Seventh Circuit held that the transfer of public housing notes for which tax-exemption formerly was provided under section 11b of the Housing Act of 1987 was not subject to Federal estate tax. *Haffner* v. *U.S.*, 757 F. 2d 920 (7th Cir., 1985), affg. 585 F. Supp. 354 (N.D., Ill., 1984). This decision applies only to such transfers that occurred before June 19, 1984.

# IV. LEGISLATIVE BACKGROUND OF THE TAX-EXEMPTION FOR PRIVATE ACTIVITY BONDS

Federal income tax law has provided an exemption for interest on obligations issued by or on behalf of States or local governments since the income tax was enacted in 1913. General obligation bonds were first issued by some State and local governments to provide financing for private business activities in the 1930's. By 1954, the Internal Revenue Service had ruled favorably on the use of revenue bonds to provide financing for private businesses. (Rev. Rul. 54-106, 1954-1 C.B. 28.)

## A. Industrial Development Bonds

### *1968 proposed regulations and subsequent legislation*

The volume of tax-exempt bonds to provide financing for private business activities was relatively small until the 1960's. At that time, the volume of these obligations began to grow rapidly. In response to this increased volume, on March 22, 1968,[51] the IRS issued proposed regulations regarding private activity bonds. The regulations provided that, in general, interest on IDBs would thereafter be taxable if (1) an identifiable party other than the issuing governmental unit had the right to use all or a major portion of the bond proceeds or the property acquired with bond proceeds, (2) that party was responsible for all or a major portion of the principal and interest payments, and (3) the payments were secured by an interest in the financed property.

In response to the increased volume of IDBs, and the proposed regulations, Congress enacted the first statutory provisions limiting the circumstances under which interest on IDBs would be tax-exempt as part of the Revenue Adjustment Act of 1968.[52] This 1968 Act provided that interest on IDBs generally is taxable. Exceptions were provided, however, in the form of a list of activities for which tax-exempt IDB financing could be provided (exempt-activity IDBs) and a more general exception for certain small issues (the small-issue exception).

The original exempt activities were—

(1) Residential real property for family units capable of maintaining families on a nontransient basis;

(2) Sports facilities;

(3) Convention or trade show facilities;

(4) Airports, docks, wharves, mass commuting facilities, parking facilities, or storage or training facilities related to one of the above;

[51] 33 Fed. Reg. 4950 (March 22, 1968).
[52] P.L. 90-364.

(5) Sewage or solid waste disposal facilities, or facilities for local furnishing of électric energy, gas, or water; and

(6) Air or water pollution control facilities.

An additional exception was provided for bonds issued to finance the acquisition of land for an industrial park, meaning a tract of land suitable for industrial, distribution, or wholesale use, and controlled by the government itself.

Finally, as stated above, an exception to the general limitation on, tax-exemption for interest on IDBs was provided for certain small issues. Under the original small-issue exception, if the aggregate face amount of an issue did not exceed $1 million, and substantially all of the proceeds were to be used to acquire or construct depreciable property or land, the interest on the bonds was tax-exempt. However, in measuring the $1 million limitation, the face amount of any outstanding prior small issues was included in determining the total amount of an issue, if the prior issues were for property used by the same principal user.

The $1 million small-issue limit was modified later in 1968[53] to permit governmental units to elect to increase the $1 million limit to $5 million if both outstanding issues and certain capital expenditures by principal users of the bond-financed property incurred over a six-year period, beginning three years before the date of the issue and ending three years after the date of the issue, were taken into account. This Act also provided that certain specified capital expenditures are excluded from this computation. These excluded capital expenditures were limited in 1968 to $250,000. If capital expenditures after the date of the issue caused the issue to be disqualified for tax-exemption because they, when added to the issue and prior related issues, exceeded the small-issue limitation of $5 million, loss of tax-exemption was to be effective only from the date of the disqualifying capital expenditures.

### *Tax Reform Act of 1969 arbitrage rules*

The Tax Reform Act of 1969[54] provided rules restricting the ability of State and local governments to invest the proceeds of tax-exempt bonds in other obligations that provide a yield materially higher than the yield on the tax-exempt bonds (i.e., arbitrage bonds).

### *1971 increase in excluded capital expenditures for small-issue IDBs*

The next amendments to the IDB provisions were made by the Revenue Act of 1971.[55] In the 1971 Act, the limitation on certain subsequent capital expenditures that are permitted without disqualifying the tax-exempt status of small-issue bonds was increased from $250,000 to $1 million.

### *Certain dam construction as an exempt activity*

In 1975,[56] Congress added a new exempt activity, permitting tax-exempt IDB financing for dams that furnish water for irrigation

[53] The Renegotiation Amendments Act of 1968 (P.L. 90-634).

[54] P.L. 91-172.

[55] P.L. 92-178.

[56] The Revenue Adjustment Act of 1975 (P.L. 94-164).

purposes and that have a subordinate use for the generation of electricity. The exception applies only if substantially all of the stored water is contractually available for release from the dam for irrigation purposes upon reasonable demand by and for members of the public.

### *1978 expansions of tax-exemption for IDBs*

The Revenue Act of 1978[57] increased the elective $5 million limit on small-issue IDBs to $10 million, and permitted exclusion of up to $10 million of capital expenditures for facilities with respect to which an urban development action grant (UDAG grant) is made. That Act also defined the local furnishing of electricity to include furnishing to an area comprising not more than a city and one contiguous county in addition to the previous interpretation (contained in Treasury regulations) of two contiguous counties. Finally, that Act provided rules clarifying when water facilities are considered to be provided to the public and prohibiting advance refunding of IDBs, except in limited cases.

### *1980 restriction of rental housing as an exempt activity*

In 1980, IDBs for residential rental property were limited to bonds used to finance multifamily residential rental property having a minimum percentage of its housing units occupied by individuals of low- or moderate-income. These restrictions were added as part of the Mortgage Subsidy Bond Tax Act of 1980, discussed below, which also restricted the use of tax-exempt financing for single-family housing. In general, these restrictions require that at least 20 percent of the units in each project be rented to persons of low -or moderate-income (defined as persons with incomes of less than 80 percent of the area median income).

### *Financing of mass commuting vehicles as an exempt activity and exemption of certain volunteer fire department bonds*

In 1981, the Economic Recovery Tax Act[58] (ERTA) further expanded the exempt activities for which IDBs may be issued to include financing of certain mass commuting vehicles. (Mass commuting terminal facilities were among the original exempt activities.)

ERTA also provided that obligations of certain volunteer fire departments are tax-exempt as obligations of a political subdivision of a State, if the bond proceeds are used to acquire or improve a firehouse or fire truck to be used by the fire department.

### *TEFRA restrictions on private activity bonds*

The Tax Equity and Fiscal Responsibility Act of 1982[59] (TEFRA) made the following changes to the IDB rules:

[57] P.L. 95-600.
[58] P.L. 97-34.
[59] P.L. 97-248.

(1) Issuers of private activity bonds[60] are required to make quarterly information reports to the IRS concerning bonds issued by them;

(2) Issuance of IDBs was required to be approved by an elected official in the issuing jurisdiction, and all jurisdictions where the facilities were to be located, following a public hearing (or approved pursuant to a voter referendum conducted in lieu of the elected official approval and public hearing);

(3) Cost recovery deductions were reduced, with certain exceptions, for IDB-financed property;

(4) The average length of time to maturity of IDBs is limited to 120 percent of the economic life of the property financed;

(5) The definition of facilities for the local furnishing of gas was expanded to parallel the rules for local furnishing of electric energy (adopted in 1978), and a new exception for local district heating and cooling facilities enacted; and

(6) Special rules were enacted allowing advance refunding of certain port authority bonds and financing the purchase of certain regional pollution control facilities.

Additionally, the small-issue exception was repealed, to be effective at the end of 1986. In the interim, new restrictions were placed on bonds issued pursuant to that exception. First, use of these bonds to finance certain recreational, automobile service, food service facilities, and certain private sports facilities was prohibited. Additionally, the use of small-issue IDBs in conjunction with IDBs for an exempt activity also was restricted, and new rules were provided for determining when simultaneously issued bonds constitute a single issue and when such bonds are multiple issues qualifying for tax-exemption under the small-issue exception.

### *Deficit Reduction Act of 1984 amendments*

The Deficit Reduction Act of 1984 (the 1984 Act)[61] imposed volume limitations on the aggregate annual amount of private activity bonds (all student loan bonds and most IDBs) that may be issued by each State and its political subdivisions. In addition to the volume limitations, the 1984 Act also made the following major changes to the rules governing IDBs:

(1) Three of the four TEFRA exceptions to the ACRS restrictions on tax-exempt bond financed property were repealed, with only projects for multifamily residential rental property remaining eligible for full ACRS deductions;

(2) Additional arbitrage restrictions, requiring a rebate of certain profits and limiting the amount of bond proceeds that may be invested in obligations unrelated to the purpose of the issue, were enacted for IDBs (other than IDBs for multifamily residential rental property);

(3) Limitations were placed on the amount of IDB proceeds that may be used to finance the acquisition of land and certain specified

[60] Under the information reporting requirements, the term private activity bond includes IDBs, scholarship funding bonds, and bonds issued by charitable, educational, religious, and scientific organizations (described in sec. 501(c)(3)). This is broader than the definition of the term private activity bond for purposes of the state volume limitations adopted in 1984.

[61] P.L. 98-369.

facilities and the circumstances in which existing property may be financed with IDBs;

(4) The special rule under which IDBs for certain airports, docks, wharves, and convention and trade show facilities could be advance refunded was repealed;

(5) The Act clarified that tax-exempt bond financed multifamily residential rental property may be part of a building that also is used for nonresidential purposes; and

(6) The rule under which tax-exempt bonds may not be owned by a substantial user of the bond-financed property was extended to treat certain related parties to substantial users as users of the property.

In addition, three changes were made to the small-issue exception. First, the exception was extended through 1988 for manufacturing property. Second, the small-issue exception was limited to persons benefiting from $40 million or less in all types of IDBs. Third, the 1984 Act provided that multiple issues are aggregated for purposes of the small-issue capital expenditure limitations when the bonds are issued for a single building or a group of related facilities.

The 1984 Act also made certain changes applicable to all tax-exempt bonds. These changes are discussed in IV. D., below.

## B. Single-Family Housing Bonds

*Mortgage Subisdy Bond Tax Act of 1980*

The Mortgage Subsidy Bond Tax Act of 1980[62] imposed the first statutory restrictions on the ability of States and local governments to issue tax-exempt bonds for financing mortgage loans for single-family housing. State housing agencies began issuing some mortgage subsidy bonds in the early 1970s. Before 1978, however, most State housing finance agency bonds were issued to provide multifamily rental housing.[63] Dramatic increases in the volume of tax-exempt bonds for single-family, owner-occupied housing during the late 1970s led to enactment of the 1980 Act.

The 1980 Act provides that interest on mortgage subsidy bonds is tax-exempt only if the bonds are qualified veterans' mortgage bonds or qualified mortgage bonds. Qualified veterans' mortgage bonds are general obligation bonds, the proceeds of which are used to finance mortgage loans to veterans. The 1980 Act exempted qualified veterans' mortgage bonds from the volume, arbitrage, and targeting limitations applicable to qualified mortgage bonds. The 1980 Act required qualified mortgage bonds to satisfy several requirements:

(1) Qualified mortgage bonds were required to be issued before January 1, 1984.

(2) The aggregate annual volume of such bonds that a State, and local governments within the State, may issue was limited to the greater of (1) 9 percent of the average annual aggregate principal amount of mortgages executed during the 3 preceding years for single-family owner-occupied residences located within the State, or (2) $200 million.

(3) The bond proceeds were required to be used to finance the purchase of single-family residences that are located within the jurisdiction of the issuing authority and that are reasonably expected to become the principal residences of the mortgagors.

(4) With limited exceptions, only new mortgage loans could be made from the bond proceeds.

(5) At least 20 percent of the proceeds of each issue generally was required to be available for financing residences in certain low- and moderate-income "targeted" areas.

(6) All of the mortgage loans made from each issue generally were required to be made to mortgagors who did not have a present ownership interest in a principal residence at any time during the 3-year period ending on the date their mortgage loans were made.

[62] Title XI of the Omnibus Reconciliation Act of 1980 (P.L. 96-499).

[63] The tax-exemption for bonds for multifamily residential rental property remains as an exempt activity under the IDB rules.

(7) All of the mortgage loans were required to be made to finance the purchase of residences for which the acquisition cost did not exceed 90 percent (110 percent in targeted areas) of the average area purchase price applicable to the residence.

(8) Each issue of qualified mortgage bonds was required to satisfy certain special arbitrage restrictions, both as to mortgage loans and nonmortgage investments.

### *TEFRA amendments to eligibility and arbitrage requirements*

TEFRA amended the first-time homebuyer and purchase price restrictions for qualified mortgage bonds (items 6 and 7, above). After TEFRA, only 90 percent of the mortgage loans financed by an issue are required to be made to first-time homebuyers, and the purchase price limit for homes is 110 percent (120 percent in targeted areas) of the average area purchase price.

Finally, TEFRA increased the permissible arbitrage earnings on qualified mortgage bonds and provided that, for purposes of the requirement that nonmortgage investments bearing a yield higher than that of the issue be liquidated in certain cases, no liquidation is required when a loss in excess of the amount of undistributed arbitrage profits in nonmortgage investments would result.

### *1984 Act amendments*

The 1984 Act restricted the issuance of qualified veterans' mortgage bonds to States that had issued those bonds before June 22, 1984, imposed State volume limitations on the amount of the bonds that may be issued, and restricted mortgage loans made with the bond proceeds to loans to veterans who served on active duty before 1977 and who apply for a loan before a specified date.

The 1984 Act also reenacted and extended through December 31, 1987, the authority to issue tax-exempt qualified mortgage bonds. The requirements applicable to these bonds are the same as applied before expiration of the provision at the end of 1983.

Additionally, the 1984 Act authorized States to exchange all or a portion of their qualified mortgage bond volume authority for authority to issue MCCs. MCCs generally are subject to the same eligibility requirements as qualified mortgage bonds.

## C. Qualified Scholarship Funding Bonds

*1976 restrictions*

In the early 1970s, some States sought to use tax-exempt bonds to finance student loan programs for college students. These programs were partly in response to Federal education programs which provided incentive payments to institutions offering student loans. Typically, the programs involved not-for-profit corporations organized by the State to issue the bonds rather than the States doing so themselves. Therefore, a question arose as to whether the bonds were issued by or on behalf of the States. Additionr<sup></sup>llv, the use of tax-exempt bond proceeds to acquire student notes ..caring nonexempt interest could have violated the arbitrage rules adopted in 1969.

In response to this situation, the Tax Reform Act of 1976 provided a new exemption for interest on qualified scholarship funding bonds. To be exempt, these bonds must be obligations of not-for-profit corporations organized by, or requested to act by, a State or a political subdivision of a State (or of a possession of the United States), solely to acquire student loan notes incurred under the Higher Education Act of 1965. The entire income of these corporations (after payment of expenses and provision for debt service requirements) must accrue to the State or political subdivision, or be required to be used to purchase additional student loan notes.

*1984 Act restrictions*

Student loan bonds are private activity bonds subject to the State volume limitations imposed under the 1984 Act. The 1984 Act further limited tax-exemption for student loan bonds to those bonds repayment of which is guaranteed under the GSL or PLUS programs of the Department of Education, effective for bonds issued after July 18, 1984. Finally, the 1984 Act provided that, subject to Treasury Department regulations, additional arbitrage restrictions like those applicable to IDBs will apply to tax-exempt student loan bonds. The legislative history accompanying this provision indicates that these rules may require rebate of certain arbitrage profits and may restrict investment of student loan bond proceeds in investments unrelated to the purpose of the bonds.

## D. Tax-Exemptions Provided by Federal Statutes Other Than the Internal Revenue Code

In addition to the activities for which tax-exempt financing is provided under the Internal Revenue Code, certain nontax statutes provided an exemption for interest on specified obligations before 1983. Bonds issued pursuant to these non-Code exemptions generally were not subject to the restrictions on tax-exempt bonds contained in the Internal Revenue Code.

### *District of Columbia bonds*

Under the District of Columbia Self-Government and Governmental Reorganization Act,[64] the District of Columbia is authorized to issue (1) general obligation bonds and (2) revenue bonds and notes for use in the areas of housing, health, transit and utility facilities, recreational facilities, college and university facilities, pollution control facilities, and industrial and commercial development. Under that Act, the obligations were exempted from all Federal and District taxation (except gift, estate, and generation-skipping transfer taxes).[65]

The Internal Revenue Service held that interest on bonds and notes issued by the District of Columbia, before 1984, was exempt from Federal income taxes notwithstanding the IDB provisions of the Internal Revenue Code.[66] Thus, the District could issue bonds for industrial and commercial development without regard to the limitations on small-issue IDBs; however, IRS concluded that the District of Columbia did not have the authority to issue arbitrage bonds.

### *Bonds issued by U.S. possessions*

#### *Puerto Rican bonds*

Under the Puerto Rico Federal Relations Act,[67] interest on bonds issued by the Government of Puerto Rico, or by its authority, was exempted from Federal, State, or Puerto Rican taxation.

#### *Virgin Islands and American Samoa bonds*

The government of the Virgin Islands may issue general obligation and other bonds for public works, slum clearance, urban redevelopment, or to provide low-rent housing. Since 1984, the Virgin Islands also may issue IDBs.[68] Interest on bonds issued by the Virgin Islands (or any municipality thereof) may be exempt from Federal, State, or Virgin Islands taxation.[69]

[64] 87 Stat. 774 (1973); Pub. L. 93-198.

[65] D.C. Code sec. 47-332.

[66] Rev. Rul. 76-202, 1976-1 C.B. 26.

[67] Laws 1917, c. 145, 39 Stat. 953 (48 U.S.C. sec. 745).

[68] P.L. 98-369.

[69] Pub. L. 418, 81st Cong., 1st Sess. (1949) (48 U.S.C. sec. 1403).

The Government of American Samoa is authorized to issue tax-exempt IDBs.[70]

### *State and local housing agency bonds*

Section 11(b) of the Housing Act of 1937[71] provided that interest on certain obligations issued by State and local public housing agencies in connection with low-income housing projects is tax-exempt. This tax-exemption is limited to bonds for projects developed, acquired, or assisted by the State or local agency. The project units generally must be rented to families whose incomes do not exceed 80 percent of the median income for the area (as determined by the Department of Housing and Urban Development).

### *1982 amendment*

The Surface Transportation Assistance Act of 1982 [72] expanded the scope of the tax-exemption provisions of the Internal Revenue Code (sec. 103(a)) to include obligations the interest on which previously was tax-exempt under Federal statutes other than the Code. This Act did not, however, extend substantive Code restrictions to non-Code bonds.

### *1984 Act amendments*

The 1984 Act expanded the application of Internal Revenue Code provisions to bonds authorized by other Federal statutes. Under the 1984 Act, these non-Code bonds must satisfy all Code provisions that apply to bonds issued under the Code for like purposes. The specific Code provisions extended to non-Code bonds are (1) the State private activity bond volume limitations, (2) the Code arbitrage restrictions, (3) the public approval and information reporting requirements for private activity bonds, (4) the requirement that obligations be issued in registered form, (5) the disallowance of tax-exemption for Federally guaranteed obligations, and (6) the private loan bond restriction.

[70] P.L. 98-369.
[71] 42 U.S.C. sec. 1437i(b).
[72] P.L. 97-424.

## E. 1984 Restrictions on Tax-Exempt Bonds Generally

The 1984 Act included four provisions of general application to tax-exempt bonds, including bonds issued for private activities.

### *Private loan bond restriction*

The 1984 Act provided that interest on bonds issued to provide loans to nonexempt persons is taxable. Private activity bonds for which Congress previously has authorized tax-exemption (i.e., IDBs, MSBs, and qualified student loan bonds) are not subject to this restriction. In addition, an exception is provided for bonds issued to enable the borrower to finance any tax or governmental assessment of general application.

### *Prohibition on Federal guarantees*

The 1984 Act generally prohibited tax-exemption for interest on bonds that are guaranteed, in whole or in part, by a direct or indirect guarantee of the Federal Government. Exceptions were provided for certain guarantee programs in existence when the 1984 Act was enacted.

### *Transfer tax treatment of tax-exempt bonds*

The 1984 Act provided that the Federal gift, estate, and generation-skipping transfer taxes apply to transfers of tax-exempt bonds unless an exemption that specifically refers to the gift, estate, or generation-skipping provisions of the Internal Revenue Code is enacted. (At the present time, no bonds are exempt from these Federal transfer taxes.)

### *Future grants of tax-exemption*

The 1984 Act provided that all future grants of exemption from Federal tax must be enacted as part of a revenue Act.

# V. DESCRIPTION OF TAX REFORM PROPOSALS

## A. Administration Proposal

### *Tax-exemption generally*

### *Repeal of tax-exemption for nongovernmental bonds*

*General rule*

Under the Administration proposal, interest on State and local government bonds would be tax-exempt only if the bonds were "governmental" bonds. Bonds would be governmental bonds if no more than one percent of the bond proceeds were used directly or indirectly by any person other than a State or local government. The use of bond proceeds would include the use of property financed with those proceeds.[73] Thus, interest on IDBs, MSBs, and student loan bonds (using present-law definitions), as well as bonds to benefit charitable organizations (described in sec. 501(c)(3)), would no longer qualify for tax-exemption.[74] Tax-exemption would continue to be permitted for interest on bonds issued to finance State or local government operations (including TANs and RANs) and to finance the acquisition or construction of government buildings. These rules would apply both to general obligation bonds (i.e., bonds backed by the general revenues of the issuing government) and revenue bonds (i.e., bonds to be repaid from the revenues from a specific project).

If bond-financed property were used partially for governmental purposes and partially for nongovernmental purposes, an allocable portion of the property could be financed with tax-exempt bonds. As illustrated in the Administration proposal,[75] if a government-owned and -operated electric generating facility contracted to sell 10 percent of its output over the life of the facility to an investor-owned utility, and supplied the remaining 90 percent of the power generated by it directly to the general public, 90 percent of the costs of the facility could be financed with tax-exempt bonds. (A government-owned and -operated utility that provided electricity to the general public would qualify for tax-exempt financing under the proposal.)

[73] The Administration proposal would discontinue the present-law concepts of exempt activity and public *versus* private use. The concept of use, discussed in II.C., above, would continue to be relevant for determining whether the use of bond proceeds was by a governmental entity, and thus whether the bonds were governmental bonds.

[74] A few bonds that are IDBs under present law would be governmental bonds under the Administration proposal. For example, bonds to finance the extension of a governmental sewer system to serve a single corporation are IDBs under present law, but would be governmental bonds, and thereby eligible for tax-exemption under the Administration proposal.

[75] The governmental use requirement is described on on p. 282 *et seq.* of the Administration proposal.

*Exceptions*

The Administration proposal includes three exceptions to the governmental use restriction—a special rule for certain facilities, owned and operated by a governmental unit, that are available to the general public on the same basis; a *de minimis* exception for certain short-term leases and management contracts; and an exception for certain investments relating to temporary periods or to reasonably required reserve or bona fide debt service funds.

*Requirement of availability on the same basis to all members of the general public.*—Under the Administration proposal, the use of bond-financed property, owned and operated by a governmental unit, by a nongovernmental person would not result in a denial of tax-exempt financing, if the property were available for use by all members of the general public on the same basis. The use of bond-financed property by one or more nongovernmental persons on a basis other than that available to the general public would, however, result in loss of tax-exemption. Such a different use by one or more nongovernmental persons could be demonstrated by a formal or informal agreement between the governmental unit and the nongovernmental person, or by the fact that the property was located at a site that was not readily accessible to the general public. As an example, the Administration proposal states that extension of a road, sewer, or similar system to a newly constructed house or business could continue to be financed with tax-exempt obligations. However, construction of an airstrip adjacent to a business that would be the primary user of the airstrip could not be so financed.

The Administration proposal states that a facility used by a nongovernmental person would not qualify for this exception merely because it also is used by the general public. For example, a leased airline terminal could not be financed with tax-exempt bonds, since the airline's use of the terminal would be on a basis different from that available to the general public.

*Exception for short-term contracts and initial-period leases.*—The leasing of property to a nongovernmental person, or its operation by such a person pursuant to a management contract, ordinarily would disqualify the property from tax-exempt financing under the Administration proposal. Similarly, tax-exempt financing generally would not be available for property operated by nongovernmental persons, pursuant to management contracts. An exception would be provided for management contracts of one year or less in duration. For example, a solid waste disposal facility owned by a city government and serving the general public in the city could be financed with tax-exempt obligations if it were operated either (1) by the city, or (2) by a private manager under a short-term (one year or less) management contract.

An exception also is provided for certain leases of one year or less duration; however, this exception is limited to the period immediately after substantial completion of construction of the bond-financed property. Other leases to nongovernmental persons would preclude the use of tax-exempt financing for the property (or the leased portion thereof).

*Exception for certain temporary period investments.*—Bond proceeds could be invested for an initial temporary period without loss of tax-exempt status.[76] Exceptions also would be provided for (1) reasonably required reserve funds, and (2) bona fide debt service funds, both defined as under present law.

### *Additional arbitrage restrictions*

The Administration proposal would extend additional arbitrage restrictions, similar to the present-law rules applicable to IDBs and mortgage subsidy bonds, to all tax-exempt bonds. Under these additional restrictions, investments not directly related to the purpose for which bonds are issued (i.e., investments in acquired nonpurpose obligations) would be limited to 150 percent of annual debt service, with exceptions for an initial temporary period and for bona fide debt service funds.

Additionally, all tax-exempt bond issuers would be required to rebate arbitrage profits on nonpurpose obligations to the United States.[77] For this purpose, profits would be adjusted for gains and losses on the nonpurpose obligations and for earnings on the arbitrage profits themselves (as under the present-law IDB rules). For purposes of determining the amount of arbitrage profits, the yield of a bond issue would be determined without regard to costs (including underwriter's discount, issuance costs, credit enhancement fees, and other costs). The yield on acquired obligations similarly would be determined without regard to costs.

The present-law rules, under which unlimited arbitrage may be earned during certain initial temporary periods of up to three years, also would be restricted under the Administration proposal. No temporary period would be allowed for bond issues that financed the acquisition of property. In the case of construction projects, the temporary period would end when the project was substantially complete, or when an amount equal to the bond proceeds has been expended on the project.

In no event could the temporary period exceed three years. In conjunction with these changes, the option to waive the temporary period and earn an 0.5 percent (rather than 0.125 percent) arbitrage spread would be repealed.

### *Restriction on early issuance of bonds*

Early issuance of tax-exempt bonds would be restricted more tightly than under present law. An issuer would be required to spend a significant portion of the bond proceeds within one month of the issue. All bond proceeds would be required to be expended within three years of the date of issue, with an exception for reasonably required reserve and replacement funds.

### *Prohibition of all advance refundings*

The Administration proposal would prohibit advance refundings of all tax-exempt bonds. Advance refundings would be defined to include any refunding when the refunded bonds were not redeemed

[76] *But see,* the discussion below of proposed new restrictions on the length of permitted temporary periods during which unlimited arbitrage profits could be earned.

[77] But the proposal does not specify any exceptions to this rebate requirement. The present-law IDB rules allow exceptions (1) where the gross proceeds of the issue are expended for a governmental purpose within 6 months of the issue date, and (2) for certain debt service funds. (*See,* II.D., above.)

immediately (i.e., the 180-day rule of present law for IDBs and mortgage subsidy bonds would be repealed).

### *Information reporting and other requirements*

The present-law information reporting requirements for IDBs would be extended to all tax-exempt obligations.

### *Deductibility of expenses related to tax-exempt income*

In addition to the proposed restrictions on tax-exempt financing generally, the Administration proposal also would deny banks a deduction for any interest payments that are allocable to the purchase or carrying of tax-exempt obligations. The amount of interest allocable to tax-exempt obligations would be determined as it is for purposes of the 20 percent reduction in preference items under present law.[78] Thus, a deduction would be denied for that portion of a bank's otherwise allowable interest deduction that is equivalent to the ratio of (1) the average adjusted basis during the year of tax-exempt obligations held by the bank,[79] to (2) the average adjusted basis of all assets held by the bank. For example, if an average of one-third of a bank's assets over the year consisted of tax-exempt obligations, the bank would be denied one-third of its otherwise allowable interest deduction. This prorata presumption could not be rebutted by evidence of the bank's purpose in incurring interest payments.[80]

### *Minimum taxes*

The Administration proposal would impose alternative minimum taxes on individuals and corporations. As under present law, tax-exempt interest would not be treated as a preference item.

[78] *See*, III.C., and II.E., above.

[79] For this purpose, only obligations acquired after December 31, 1985, would be taken into account.

[80] This provision will be analyzed more completely in a subsequent pamphlet on tax reform proposals regarding financial institutions.

## B. Congressional Proposals

### *Tax-exemption generally*

The Bradley-Gephardt (S. 409 and H.R. 800) and Kemp-Kasten (H.R. 2222 and S. 1006) bills would repeal the tax-exemption for interest on IDBs and mortgage subsidy bonds. Repeal of authority to issue qualified mortgage bonds also would have the effect of terminating authority to issue MCCs. Tax-exemption also would be denied for interest on obligations the proceeds of which are used by charitable organizations (described in sec. 501(c)(3)), or to finance loans to individuals for educational expenses (student loan bonds).

The present-law arbitrage rules would be retained without change under these bills.

### *Minimum tax and preference reduction proposals*

The Russo-Schumer minimum tax bill (H.R. 2424) would impose an expanded alternative minimum tax for both individuals and corporations. The tax would be imposed at a 25 percent rate on alternative minimum taxable income of $100,000 or more for individuals and $150,000 or more for corporations. The tax would be phased in for income levels in excess of $70,000. Interest on tax-exempt obligations issued after the date of the bill's enactment would be treated as a preference item, and thus would be included in the alternative minimum tax base.

# VI. ISSUES RAISED BY THE TAX-EXEMPTION OF INTEREST ON STATE AND LOCAL GOVERNMENT BONDS

## A. Issues Related to the Effect of Tax-Exempt Bonds on the Tax System and the Economy

Permitting tax-exemption for interest on bonds issued by State and local governments raises numerous policy issues. These issues include (1) the effect of permitting tax-exemption for certain types of income on the overall fairness of the tax system; (2) the effect of tax-exempt private activity (nongovernmental) bonds on the cost of financing traditional government activities; (3) the efficiency of tax-exemption as a means of providing a Federal subsidy to selected activities; (4) the change in market allocation of capital that may result from tax-exempt bonds; and (5) governmental *versus* nongovernmental use of bond proceeds and bond-financed property.

### *Effect on fairness of the tax system*

Outstanding tax-exempt bond holdings totaled $539 billion at the end of 1984. This amount represents an increase of $54 billion over the $485 billion year-end total for 1983.[81] The bulk (about 94 percent in 1983 and 1984) of the bonds were held by four groups: households, mutual funds, commercial banks, and insurance companies (other than life insurance).

Households and mutual funds holding tax-exempt bonds represent individuals who have found tax-exempt yields more attractive than the after-tax yields on taxable investments. Since the ratio of tax-exempt to taxable yields has been above 65 percent during the past five years,[82] joint return filers with a 33-percent o~~r, hig~~her marginal tax rate (i.e., having taxable income above $35,200), and individual filers in a 34-percent or higher marginal tax bracket (taxable income above $28,800) would increase their after-tax yield by investing in tax-exempt bonds. Since 1980, households have increased their holdings of tax-exempt bonds both absolutely and as a percentage of the outstanding amount of such bonds (from 25.5 percent at the end of 1980 to 38.1 percent at the end of 1984). Mutual funds specializing in tax-exempt bonds have increased seven-fold since 1980, and their share of the total amount invested in these obligations has increased from 1.8 to 8.3 percent.

The widespread use of tax-exempt debt raises questions about the fairness of the tax system. This issue arises both with respect to tax-exempt borrowers and with respect to investors in tax-exempt bonds. Some persons suggest that by reducing the costs of capital to

[81] These statistics are shown in more detail Tables 1, 9, and 10 in VII.A., below. Those tables show the year-end amounts and distribution of ownership of tax-exempt bonds held by various groups from 1972 through 1984.

[82] *See*, the table accompanying the discussion of the efficiency of tax-exempt bonds as a means of providing a Federal subsidy, below, and also Table 7 in Part VII.A.

some businesses, tax-exempt financing for private activities puts at a disadvantage businesses that must pay market interest rates. The loss of fairness (or its perception) becomes more important to business as firms in closely related lines of business in the same marketing areas pay different interest rates as a result of the nonmarket decisions that determine who receives tax-exempt financing.

Similarly, investors in tax-exempt bonds gain after-tax income advantages that are unrelated to the concepts of ability-to-pay and fairness-of-tax-burden within (and between) income classes. Although many aspects of the tax structure have changed, the ability-to-pay and progressive rate concepts have remained a basic part of the tax structure. The fairness issue is most pronounced when the use of tax-exempt bonds and other sheltering devices so change the distribution of after-tax income that higher income taxpayers pay proportionately less income tax than lower income taxpayers—with some high income taxpayers reportedly being able to avoid paying any Federal income tax. On the other hand, a basic principle of tax law also is that no person need pay more taxes than the law requires. Reduction of tax liability through investment in tax-exempt bonds is in this respect no different from any other considerations (deductions, etc.) that may reduce taxable income.

Proponents of restricting or eliminating tax-exempt financing for private activities suggest that tax-exempt income is inconsistent with basic rate reduction embodied in all three of the major tax reform proposals currently before Congress. These persons suggest that the trade-off for low rates is full taxation of economic income, including tax-exempt interest. Some of these persons suggest that, even if tax-exempt income were not taxed under the basic income tax, this income should be treated as a preference item under any restructured minimum tax. The proponents of subjecting all economic income to tax state that steps such as these are necessary if unfairness, either actual or perceived, is to be avoided in any reformed tax structure.

Opponents of making interest on State and local government bonds taxable (or of treating the interest as a minimum tax preference item) suggest that such proposals are inconsistent with the principle of comity between the States and the Federal Government, and possibly might be unconstitutional.[83] These opponents suggest that this principle is particularly important given reduced direct Federal spending for various activities (including for exam-

[83] The Code has provided since 1968 that interest on IDBs is taxable unless a specific exception is provided in the Code. Since 1980, the tax law has provided that interest on mortgage subsidy bonds is taxable unless Code restrictions are satisfied. Additionally, the Deficit Reduction Act of 1984 provided that interest on all bonds the proceeds of which are used to finance loans to nonexempt persons is taxable unless a specific Code exception allows tax-exemption.

In the only case in which it has considered this issue directly, the Supreme Court ruled that the tax-exemption of interest on State and local government bonds is constitutionally protected. (*Pollock* v. *Farmers' Loan and Trust Company* (157 U.S. 429 (1895).) That case involved debt issued for basic governmental activities as opposed to bonds for private activities. In later cases, the Court upheld the application of the Federal income tax to wages of State employees (*Helvering* v. *Gerhardt* (304 U.S. 405 (1938)) and *Graves* v. *N.Y. ex. rel. O'Keefe* (306 U.S. 466 (1939)). Some commentators have suggested that taxation of wages of State employees is a similar issue to taxation of interest on State and local government bonds.

Finally, the Federal Government statutorily has precluded the taxation of interest on its debt by States. (31 U.S.C. 3124.) This prohibition applies whether the State law results in direct or indirect consideration of the interest in computation of tax. (*American Bank and Trust Co.* v. *Dallas County* (463 U.S. 855 (1983).)

ple, housing and education), and the concomitant increase in State responsibilities in these areas. The opponents further suggest that even a reformed tax structure in which rates were significantly lower properly should not preclude special treatment in certain cases. As an exa..ple, these persons point to the deduction for mortgage loan interest incurred with respect to a principal residence, a deduction that is retained under all three of the major tax reform proposals currently before Congress. The opponents of taxing interest on State and local government bonds suggest that assistance for local economic development and other purposes represents a similar overriding social objective.

### *Effect on the cost of financing traditional government activities*

The use of tax-exempt bonds for private activities increases the competition for the limited pool of assets available for investment in tax-exempt obligations generally. The overall result is higher interest rates on tax-exempt bonds generally, including bonds issued for traditional governmental activities, as issuers of this debt must bid funds away from other uses.

Proponents of restricting tax-exempt financing for private activities suggest that the increase in the municipal-corporate bond ratio in recent years reflects the increased cost of government finance, including increased costs of providing local capital improvements. (*See*, Table 7 in VII.A., below.) These persons suggest that, as a result of the widespread availability of tax-exempt financing for private activities, tax-exempt bond yields are higher than the yields necessary to induce investment in State and local government obligations.

Opponents of restricting tax-exempt financing for private activities suggest that the term private-activity is a misnomer. These persons suggest that the so-called private activities for which tax-exempt financing currently is permitted serve a public purpose, even if only indirectly. These persons suggest that financed activities may be in the nature of public works, even though a private user may enjoy the benefit of the tax-exempt financing. In addition, the opponents suggest that increases in employment and expansion of the local tax base are public activities of sufficient importance to justify any increase in other interest expenses incurred for traditional governmental activities, even if such increases result in higher yields to bond investors than are needed to induce investment.

### *Efficiency of tax-exempt bonds as a means of providing a Federal subsidy*

Tax-exempt financing for private activities provides a direct Federal subsidy to at least two parties to each transaction—the borrower and the bond investor (the lender).[84] The private borrower receives a Federal subsidy equal to the difference between the tax-exempt interest rate paid and the taxable bond rate that otherwise would be paid.[85] Column 3 of Table 7 in VII.A., below, may be used

[84] These subsidies are in addition to any benefits received by the State or local government issuing the bonds or by facilitators of the transaction, such as bond counsel and underwriters.

[85] The borrower may deduct interest costs, whether the interest income is taxable or tax-exempt to the lender.

to illustrate the measure of the borrower's subsidy measured as a percentage of the otherwise applicable taxable rate. For example, for 1984, if the ratio of tax-exempt to taxable rates was .749, or 74.9 percent, the subsidy was equal to 25 percent of the taxable rate, or approximately 2.5 percentage points on a 10-percent taxable rate.

The bond investor also receives a Federal subsidy from tax-exempt financing equal to the difference between the tax-exempt interest rate and the after-tax yield on a taxable corporate investment. In many cases, the bond investor's subsidy is greater than the subsidy received by the borrower. The marginal tax rate of the bond investor determines the extent of the subsidy.

The table below illustrates that an investor in the 50-percent marginal tax bracket would receive a five percent after-tax yield on a 10-percent taxable bond. This taxpayer would receive a higher effective yield from any tax-exempt bond with an interest rate of more than 5 percent than from a taxable bond yielding 10 percent. If the bond yield ratio were .65, assuming a 10-percent taxable yield, a State or local government bond would pay 6.5 percent interest. In this case, the 50-percent marginal tax rate taxpayer would receive a subsidy of 1.5 percentage points on the yield (6.5 minus 5 percent after-tax income on the taxable bond), resulting in 30-percent more after-tax interest income than if a taxable bond had been purchased.

**After-Tax Yield on Taxable Bonds, by Marginal Rates**

[in percentages]

| Investors' marginal tax rate | Taxable bond yields | | | | | |
|---|---|---|---|---|---|---|
| | 10 | 9 | 8 | 7 | 6 | 5 |
| 50 | 5.0 | 4.5 | 4.0 | 3.5 | 3.0 | 2.5 |
| 40 | 6.0 | 5.4 | 4.8 | 4.2 | 3.8 | 3.0 |
| 35 | 6.5 | 5.9 | 5.2 | 4.6 | 3.9 | 3.2 |
| 30 | 7.0 | 6.3 | 5.6 | 4.9 | 4.2 | 3.5 |
| 25 | 7.5 | 6.8 | 6.0 | 5.3 | 4.5 | 3.8 |

Source: Joint Committee on Taxation.

Proponents of additional restrictions on private activity bonds suggest that the subsidy to borrowers provided by these bonds is very inefficient. These persons state that, for every $2 of benefit to a user of bond financed property, the Federal Government loses $3 or more in tax revenues. The foregone tax revenues may result in (1) increases in the Federal deficit; (2) higher marginal tax rates than otherwise would be necessary; or (3) reductions in other Federal Government programs. The proponents suggest that properly designed direct subsidy programs are a more efficient method of maximizing the portion of any subsidy that actually is received by intended beneficiaries of Federal subsidies.

Opponents of additional restrictions on private activity bonds suggest that the alternative to the indirect subsidy provided by tax-exempt financing is creation of new Federal bureaucracies to administer direct Federal programs. These persons suggest that the inefficiency in targeting the benefits from tax-exempt bonds is no greater than the inefficiency of such bureaucracies.

*Change in market allocation*

Tax-exempt bonds change the allocation of capital by encouraging investment in projects eligible for tax-exempt financing, at the expense of other investments. To some extent, this change is an intended result. However, in certain cases, tax-exempt bonds may encourage investment in projects that serve little or no public purpose. In particular, the availability of small-issue IDB financing may encourage small projects at the expense of larger ones, regardless of relative economic efficiency. Similarly, the tax-exemption provided for interest on mortgage subsidy bonds may encourage construction of single-family housing at the expense of industrial or commercial facilities that would develop the economic base of an area.

In addition to changing market allocation between competing investment purposes, tax-exempt bonds may change the allocation of funds between persons eligible to receive tax-exempt financing (including certain tax-exempt charitable organizations, and businesses eligible for IDB financing) and other, ineligible persons. Also, by increasing the demand for bond-financed property, tax-exempt financing may encourage increases in the prices of this property. For example, mortgage subsidy bonds, by reducing the effective mortgage interest rate, may increase the demand for eligible single-family residences. This may result in higher home prices for purchasers receiving taxable financing, as well as for those benefiting from tax-exempt financing.

Proponents of restricting tax-exempt financing for private activities suggest that, if no tax subsidy were provided, all persons engaged in private activities would have to pay market determined prices for productive resources. Thus, all borrowers with essentially the same credit rating would be charged the same rate of interest. These persons further suggest that borrowers at tax-exempt rates either (1) do not have to meet a test of whether they could operate profitably while paying the same interest cost as other borrowers, or (2) even if they could operate profitably without the subsidy, invest more extensively in the subsidized activities than they would if they had to pay market, i.e., taxable and unsubsidized, interest rates. Finally, the proponents of restricting this form of financing suggest that its principal effect is to provide an opportunity for State and local governments to use the Federal income tax base, a free good to them, as a marketing device that may cause increased taxes for other parties.

Opponents of additional restrictions on tax-exempt financing for private activities suggest that the market changes caused by tax-exempt bonds are appropriate as a means of effecting certain social objectives that Congress has determined to be sufficiently important to subsidize. These persons suggest that, without the subsidy (and accompanying change in market allocation), socially desirable activities might not occur. The opponents of further restrictions also suggest that the diversity of local needs makes additional Federal restrictions on the types of activities to be subsidized, or otherwise on the allocation of the overall subsidy allowed each State, counterproductive.

### *Governmental* v. *nongovernmental use of bond proceeds and bond-financed property*

In recent years, State and local governments increasingly have contracted with private businesses to provide, as private activities, services that by some are considered governmental services (e.g., sewage and solid waste disposal). This phenomenon is referred to as "privatization." Additionally, qualified governmental units have issued tax-exempt bonds to finance other, private, activities that many consider unrelated to governmental services (e.g., small-issue IDBs, IDBs for multifamily residential rental property and air and water pollution control facilities, and mortgage subsidy bonds).

Some proponents of restricting tax-exempt financing suggest that the indirect Federal subsidy provided by tax-exempt bonds should be permitted exclusively for those functions that actually are conducted by State and local governments. These persons suggest that it is inappropriate for the Federal Government to provide indirect subsidies for private businesses through use of the Federal tax law, particularly in times of budget constraint. Proponents of further restricting tax-exemption also suggest that the indirect Federal subsidy from bonds encourages the expansion of tax-exempt financing beyond the scope of traditional government services to new private activities.

The proponents suggest further that restricting tax-exemption to financing for services directly provided by State and local governments will not disrupt privatization of government services to the extent it is economically based, as opposed to being simply a method of shifting to the Federal Government costs that are more appropriately borne by State and local governments and private enterprise. These persons state that only those privatization projects that are profitable because of the subsidy provided by tax-exempt financing would be prevented from going forward by restrictions on such financing and that privatization resulting from private sector efficiency would continue.

Opponents of additional restrictions on tax-exempt financing suggest that many activities, nominally private, are in reality public services. The opponents of additional restrictions cite as an example bonds for airports that are IDBs because the users of the airports are private businesses (airlines) even though airports form an important necessary link in the nationwide transportation system. The opponents suggest that a governmental-nongovernmental distinction is impossible to make at the Federal level because of the diversity of different sections of the country; therefore, they suggest that discretion should be given to State and local governments.

Opponents of additional restrictions further suggest that in some instances services that are public in nature may be provided more efficiently by private businesses contracting with governmental units because of factors unrelated to the type of financing. These persons frequently cite economies of scale and greater flexibility in business management as examples of greater private sector efficiency in providing privatized services. Opponents of eliminating tax-exempt financing for these activities suggest that the fact that a private party provides a public service should not affect the nature of the available financing.

## B. Issues Related to Activities for Which Tax-Exempt Bonds May Be Issued

All of the major tax reform proposals before Congress would repeal the present tax-exemption for interest on State and local government bonds for private activities. The Administration proposal generally would permit tax-exemption only if the bond-financed property or services were governmentally used or provided. The Bradley-Gephardt and Kemp-Kasten bills would repeal the present tax-exemption for private activity bonds (IDBs, MSBs, student loan bonds, and bonds for nonprofit charitable organizations).

In most respects, the effect of these proposals is the same; however, in certain cases, bonds that are IDBs because the bond proceeds are used by a single or a limited group of users and the IDB security interest test is satisfied may be governmental bonds under the Administration proposal. For example, bonds to finance an extension of a governmentally owned and operated water system for a single manufacturing plant are IDBs, and interest on them would be taxable under both the Bradley-Gephardt and Kemp-Kasten bills. On the other hand, if the water system as a whole served all members of the public on the same basis, the interest on the bonds would be tax-exempt under the Administration proposal.

Conversely, if a city issued a single issue of bonds for several city activities, and between one and five percent of the bond proceeds were to be used indirectly to finance loans to individuals, the bond interest would be tax-exempt under both the Bradley-Gephardt and Kemp-Kasten bills while the interest would be taxable under the Administration proposal. This result would obtain because bonds are not taxable private loan bonds unless five percent or more of the proceeds are to be used for loans to nonexempt persons (a restriction that is retained by the Bradley-Gephardt and Kemp-Kasten bills). On the other hand, the Administration proposal provides that bond interest is taxable if more than one percent of the proceeds is to be used by a nongovernmental person.

In addition to considering the general concepts discussed above in VI.A., the tax reform proposals raise specific issues concerning what types of tax-exempt financing, if any, should be continued. If Congress determines that certain private activities should continue to receive tax-exempt financing, a number of issues remain to be addressed as to the volume of these bonds permitted, the types of activities eligible for such financing, and the depth of the overall Federal subsidy to be provided. The following questions illustrate specific issues that arise if such a determination is made.

### *Targeting the subsidy provided by tax-exempt bonds*

#### *Volume*

What volume of tax-exempt bond financing for private activities, if any, is appropriate?

To the extent that issuance of tax-exempt bonds for private activities is permitted, should a single annual volume limitation be imposed for all such bonds issued by or on behalf of a State and its political subdivisions rather than continuing the separate limitations presently applicable to most IDBs and all student loan bonds, to qualified mortgage bonds, and to qualified veterans' mortgage bonds?

If tax-exempt financing continues to be permitted for charitable organizations (described in sec. 501(c)(3)) and for IDBs presently excepted from the State volume limitations, should bonds for these purposes be subject to volume limitations?

Should authority for all tax-exempt financing for private activities be authorized only for a specified period to ensure periodic review of the degree to which the subsidy continues to be appropriate and effective?

Because the ability under present law to advance refund bonds other than IDBs and mortgage subsidy bonds may result in two or more issues of bonds for the same project being outstanding for an extended period of time, is it appropriate to permit such advance refundings?

#### *Types of permitted financings*

Should tax-exempt financing be available only for activities directly serving the general public, or are there activities exclusively or principally benefitting a single private party that should qualify for this subsidy?

Should tax-exempt financing be available on a proportional basis only if substantially all of the bond-financed property is used to provide a governmental service?

Should IDB financing be available only for activities presently qualifying under the exempt-activity exception when those activities entail relatively large expenditures and reflect "privatization" of governmental services? (Under such a rule, for example, facilities for the furnishing of water, sewer and solid waste disposal facilities might qualify for tax-exempt financing while air and water pollution control facilities and projects for multifamily residential rental property might not since these latter facilities normally serve a single or a limited group of private users.)

Should tax-exempt financing for privatization of certain activities be permitted only where the private business provides services to the State or local government with the government then providing such services to its citizens?

If tax-exempt financing continues to be allowed for facilities that serve limited groups (e.g., IDBs for multifamily residential rental property and mortgage subsidy bonds for single family, owner-occupied housing), should new targeting rules be enacted to ensure that a greater portion of the subsidy benefits the group with the greatest need for the subsidy?

Should the maturity of tax-exempt bonds (in addition to IDBs) be limited in relation to the economic life of the bond-financed property?

Should continued compliance with Congressional requirements for tax-exempt bonds be required throughout the period that the bonds are outstanding, and if so, should additional steps be taken to ensure that continued compliance? (For example, under present law, projects for multifamily residential rental property must satisfy the low- and moderate-income set-aside requirement for a qualified project period, but no regular reporting or evaluation of compliance is required. The sanction for noncompliance is loss of tax-exemption to the bond investor rather than a penalty (e.g., nondeductibility of interest payments) imposed on the issuer of the bonds or the user of the bond-financed property.)

*Combination of Federal subsidies*

To what extent should the combination of Federal subsidies be permitted for private activities that continue to receive the benefits of tax-exempt financing? More specifically—

*Investment credit and cost recovery deductions*

Should private ownership for tax purposes of tax-exempt bond-financed property be permitted? (If the investment credit is repealed and ACRS modified to lessen the extent of those subsidies, limitations on tax ownership would be less severe because a greater percentage of the combined Federal subsidy would be provided by the tax-exempt bonds.)

If private ownership of tax-exempt bond-financed property is permitted, should cost recovery deductions be determined using a longer period than is allowed for property financed with taxable debt?

*Federal guarantees of tax-exempt bonds*

Because the combination of tax-exemption and a Federal guarantee makes State and local bonds a more attractive investment than Federal Government debt obligations, should all Federal guarantees of tax-exempt bonds be prohibited? (The 1984 Act restricted the combination of these two benefits, but provided exceptions for numerous guarantee programs in existence at that time.)

***Arbitrage and related issues involving use of bond proceeds by issuers and parties other than ultimate beneficiaries***

Should tax-exempt bond proceeds be required to be spent for the purpose of the issue within a relatively short time after the bonds are issued? (Such a rule would preclude earlier than needed issuance of bonds primarily to earn arbitrage profits.)

Should the temporary period exceptions during which time unlimited amounts of arbitrage profits may be earned be shortened or eliminated?

Should rules such as the additional arbitrage restrictions that apply to most IDBs (e.g., a rebate requirement) be extended to all tax-exempt bonds?

Should the costs of issuance (e.g., bond counsel and underwriters' fees) be paid by the person for whom the bonds are issued rather than being recovered out of arbitrage profits?

Should all of the proceeds of an issue of tax-exempt bonds be required to be spent for the purpose for which the bonds are issued? (Under present law, 10 percent of IDB proceeds may be used for purposes other than the purpose qualifying the interest on the bonds for tax-exemption.)

# VII. REVENUE ANALYSIS

## A. Statistical Data Relating to Tax-Exempt Bonds (Other Than Mortgage Subsidy Bonds)

### *Size and composition of the tax-exempt bond market*

Table 1 shows the growth in the volume of the tax-exempt bond market, by function, from 1975 through 1984. The total volume of tax-exempt obligations increased from $30.5 billion in 1975 to $114.3 billion in 1984. During this period, the volume of bonds for private activities (including tax-exempt IDBs, student loan bonds, mortgage subsidy bonds, and bonds for use by certain nonprofit charitable organizations) increased from $8.9 billion (approximately 29 percent of total State and local government borrowing) to $71.8 billion (approximately 63 percent of State and local government borrowing). Conversely, the volume of bonds for traditional public activities, while increasing in dollar volume from $21.6 billion to $42.6 billion, decreased as a percentage of total tax-exempt bonds issued, from approximately 71 percent of total borrowings to approximately 37 percent.

## Table 1.—Volume of Long-Term Tax-Exempt Bonds by Type of Activity, Calendar Years 1975–1984

[In billions of dollars]

| | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|---|---|---|
| Total issues, long-term tax exempt bonds [1] [2] | 30.5 | 35.0 | 46.9 | 49.1 | 48.4 | 54.4 | 55.1 | 84.9 | 93.3 | 114.3 |
| Nongovernmental tax-exempt bonds | 8.9 | 11.4 | 17.4 | 19.7 | 28.1 | 32.5 | 30.9 | 49.6 | 57.1 | 71.7 |
| Housing bonds: | 1.4 | 2.7 | 4.4 | 6.9 | 12.1 | 14.0 | 4.8 | 14.6 | 17.0 | 20.0 |
| Single family mortgage subsidy bonds | * | 0.7 | 1.0 | 3.4 | 7.8 | 10.5 | 2.8 | 9.0 | 11.0 | 12.8 |
| Multi-family rental housing IDBs | 0.9 | 1.4 | 2.9 | 2.5 | 2.7 | 2.2 | 1.1 | 5.1 | 5.3 | 5.1 |
| Veterans' general obligation bonds | 0.6 | 0.6 | 0.6 | 1.2 | 1.6 | 1.3 | 0.9 | 0.5 | 0.7 | 2.1 |
| Private exempt entity bonds [3] | 1.8 | 2.5 | 4.3 | 2.9 | 3.2 | 3.3 | 4.7 | 8.5 | 11.7 | 11.6 |
| Student loan bonds | * | 0.1 | 0.1 | 0.3 | 0.6 | 0.5 | 1.1 | 1.8 | 3.3 | 1.1 |
| Pollution control IDBs | 2.1 | 2.1 | 3.0 | 2.8 | 2.5 | 2.5 | 4.3 | 5.9 | 4.5 | 7.5 |
| Small-issue IDBs | 1.3 | 1.5 | 2.4 | 3.6 | 7.5 | 9.7 | 13.3 | 14.7 | 14.6 | 17.4 |
| Other IDBs [4] | 2.3 | 2.5 | 3.2 | 3.2 | 2.2 | 2.5 | 2.7 | 4.1 | 6.0 | 14.0 |
| Other tax-exempt bonds [5] | 21.6 | 23.6 | 29.5 | 29.3 | 20.3 | 22.0 | 24.2 | 35.3 | 36.2 | 42.6 |

* $50 million or less.

[1] Total reported volume from *Bond Buyer Municipal State Book (1985)* adjusted for privately placed small-issue IDBs.

[2] This volume does not reflect amounts borrowed pursuant to installment sales agreements, financing leases, or other, non-bond, borrowing by State and local governments. *See,* II.A., above, for a discussion of the tax treatment of these types of debt.

[3] Private-exempt entity bonds are obligations issued for the benefit of section 501(c)(3) organizations such as private nonprofit hospitals and universities.

[4] Other IDBs include obligations for private businesses that qualify for tax-exempt activities, such as sewage disposal, airports, and docks.

[5] Some of these may be nongovernmental bonds.

Note.—Totals may not add due to rounding.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

***Use of tax-exempt bonds for certain charitable organizations, by State***

Table 2 sets forth the volume of tax-exempt bonds issued for charitable organizations (described in sec. 501(c)(3)) in 1984, by State. (Nonprofit tax-exempt organizations include private nonprofit hospitals and universities.) As shown in the table, the use of tax-exempt financing for these organizations varies significantly, by State. For example, Texas issued $1.447 billion of tax-exempt bonds for nonprofit charitable organizations in 1984, while Wyoming, Utah, Maine, and Alaska issued no such bonds.

**Table 2.—Volume of New Issue Tax-Exempt Bonds for Certain Charitable Organizations, by State, 1983–1984** [1]

[In millions of dollars]

| State | 1983 | 1984 |
|---|---|---|
| United States, total | 8,096 | 10,055 |
| Alabama | 103 | 338 |
| Alaska | 4 | 0 |
| Arizona | 102 | 319 |
| Arkansas | 31 | 44 |
| California | 1,210 | 783 |
| Colorado | 146 | 246 |
| Connecticut | 77 | 79 |
| Delaware | 10 | 8 |
| Florida | 610 | 748 |
| Georgia | 91 | 31 |
| Hawaii | 20 | 82 |
| Idaho | 28 | 5 |
| Illinois | 404 | 477 |
| Indiana | 384 | 315 |
| Iowa | 28 | 4 |
| Kansas | 11 | 38 |
| Kentucky | 144 | 113 |
| Lousiana | 124 | 195 |
| Maine | 4 | 0 |
| Maryland | 47 | 164 |
| Massachusetts | 698 | 506 |
| Michigan | 219 | 248 |
| Minnesota | 206 | 78 |
| Mississippi | 9 | 42 |
| Missouri | 201 | 357 |
| Montana | 5 | 26 |
| Nebraska | 13 | 116 |
| Nevada | 4 | 9 |
| New Hampshire | 35 | 45 |
| New Jersey | 334 | 252 |
| New Mexico | 77 | 13 |
| New York | 450 | 1,004 |
| North Carolina | 67 | 38 |

Table 2.—Volume of New Issue Tax-Exempt Bonds for Certain Charitable Organizations, by State, 1983-1984 [1]—Continued

[In millions of dollars]

| State | 1983 | 1984 |
|---|---|---|
| North Dakota | 41 | 27 |
| Ohio | 332 | 271 |
| Oklahoma | 33 | 3 |
| Oregon | 60 | 105 |
| Pennsylvania | 650 | 782 |
| Rhode Island | 26 | 86 |
| South Carolina | 17 | 18 |
| South Dakota | 26 | 23 |
| Tennessee | 104 | 146 |
| Texas | 0611 | 1,447 |
| Utah | 37 | 0 |
| Vermont | 8 | 32 |
| Virginia | 175 | 129 |
| Washington | 47 | 50 |
| West Virginia | 28 | 61 |
| Wisconsin | 11 | 152 |
| Wyoming | [2] | 0 |

[1] New issue volume equals the purchase price of the bond minus proceeds used to retire earlier issues.

[2] Less than $500,000.

Source: Office of the Secretary of the Treasury.

### *Use of exempt-activity IDBs and student loan bonds, by State*

Tables 3 and 4 set forth the volume of exempt-activity IDBs, and student loan bonds, by State, during 1983 and 1984, respectively. The table shows that the volume of the different types of these bonds varies significantly by State. For example, in 1983, Texas issued $1.117 billion of IDBs for multifamily residential rental property while New York issued $367 million. Similarly, in 1984, Georgia issued $1.016 billion of IDBs for air and water pollution control property while North Carolina issued $280 million of such bonds.

**Table 3.—Volume of New Issue Bonds for Selected Activities,[1] by State, 1983**

[In millions of dollars]

| State | Type of Activity | | | | |
|---|---|---|---|---|---|
| | Student loan bonds | Multi-family housing | Airport and dock, etc. | Sewage and waste disposal | Pollution control |
| United States, total | 3,086 | 5,337 | 2,089 | 1,442 | 3,411 |
| Alabama | 75 | 82 | 1 | 113 | 34 |
| Alaska | 0 | 38 | 28 | 0 | 10 |
| Arizona | 204 | 172 | 9 | 204 | 184 |
| Arkansas | 0 | 18 | 0 | 1 | 26 |
| California | 576 | 784 | 166 | 122 | 75 |
| Colorado | 133 | 81 | 21 | 7 | 42 |
| Connecticut | 16 | 82 | 13 | 0 | 0 |
| Delaware | 0 | 20 | 0 | 1 | 2 |
| Florida | 0 | 353 | 395 | 220 | 226 |
| Georgia | 0 | 328 | 40 | 1 | 24 |
| Hawaii | 0 | 0 | 57 | 0 | 0 |
| Idaho | 17 | 4 | 0 | 0 | 13 |
| Illinois | 159 | 99 | 311 | 126 | 24 |
| Indiana | 82 | 43 | 6 | 24 | 123 |
| Iowa | 60 | 13 | 0 | 0 | 4 |
| Kansas | 0 | 45 | 22 | 0 | 225 |
| Kentucky | 119 | 15 | 27 | 6 | 112 |
| Louisiana | 0 | 188 | 151 | 1 | 167 |
| Maine | 6 | 0 | 0 | 0 | 0 |
| Maryland | 0 | 296 | 48 | 236 | 10 |
| Massachusetts | 132 | 55 | 0 | 167 | 136 |
| Michigan | 0 | 96 | 0 | 11 | 151 |

### Table 3.—Volume of New Issue Bonds for Selected Activities,[1] by State, 1983—Continued

[In millions of dollars]

| State | Type of Activity | | | | |
|---|---|---|---|---|---|
| | Student loan bonds | Multi-family housing | Airport and dock, etc. | Sewage and waste disposal | Pollution control |
| Minnesota | 168 | 140 | 1 | 0 | 109 |
| Mississippi | 20 | 8 | 0 | 8 | 82 |
| Missouri | 0 | 177 | 58 | 0 | 34 |
| Montana | 34 | 16 | 0 | 1 | 75 |
| Nebraska | 0 | 9 | 0 | 0 | 6 |
| Nevada | 0 | 17 | 16 | 0 | 53 |
| New Hampshire | 42 | 0 | 0 | 0 | 75 |
| New Jersey | 0 | 48 | 67 | 4 | 102 |
| New Mexico | 42 | 11 | 0 | 0 | 22 |
| New York | 0 | 367 | 107 | 31 | 48 |
| North Carolina | 0 | 44 | 6 | 0 | 23 |
| North Dakota | 0 | 1 | 0 | 5 | 21 |
| Ohio | 198 | 7 | 20 | 3 | 140 |
| Oklahoma | 0 | 177 | 29 | 0 | 49 |
| Oregon | 0 | 0 | 6 | 0 | 0 |
| Pennsylvania | 201 | 30 | 41 | 18 | 125 |
| Rhode Island | 0 | 13 | 0 | 0 | 0 |
| South Carolina | 50 | 4 | 0 | 40 | 192 |
| South Dakota | 25 | 10 | 0 | 9 | 9 |
| Tennessee | 0 | 70 | 0 | 13 | 17 |
| Texas | 259 | 1,117 | 329 | 30 | 230 |
| Utah | 50 | 40 | 25 | 2 | 118 |
| Vermont | 75 | 8 | 0 | 2 | 0 |
| Virginia | 299 | 173 | 1 | 33 | 51 |
| Washington | 0 | 0 | 88 | 0 | 6 |
| West Virginia | 0 | 28 | 0 | 2 | 23 |
| Wisconsin | 46 | 7 | 0 | 2 | 2 |
| Wyoming | 0 | 3 | 0 | 0 | 211 |

[1] Volume for new issues is the purchase price of the bonds minus the amount used to refund previously issued obligations.

Source: Office of the Secretary of the Treasury.

## Table 4.—Volume of New Issue Bonds for Selected Activities,[1] by State, 1984

[In millions of dollars]

| State | Type of activity | | | | |
|---|---|---|---|---|---|
| | Student loan bonds | Multi-family housing | Airport and dock, etc. | Sewage and waste disposal | Pollution control |
| United States, total......... | 1,680 | 5,028 | 3,770 | 6,601 | 7,616 |
| Alabama.......................... | 0 | 0 | 29 | 55 | 260 |
| Alaska.............................. | 0 | 2 | 27 | 0 | 0 |
| Arizona............................. | 0 | 66 | 20 | 402 | 198 |
| Arkansas.......................... | 0 | 17 | 4 | 29 | 13 |
| California......................... | 426 | 927 | 339 | 552 | 309 |
| Colorado........................... | 0 | 113 | 1 | 20 | 117 |
| Connecticut....................... | 309 | 71 | 8 | 35 | 72 |
| Delaware.......................... | 0 | 7 | 0 | 0 | 168 |
| Florida............................. | 12 | 470 | 417 | 1,002 | 214 |
| Georgia............................ | 0 | 223 | 0 | 524 | 1,016 |
| Hawaii.............................. | 0 | 0 | 66 | 0 | 0 |
| Idaho................................ | 37 | 0 | 4 | 0 | 9 |
| Illinois............................. | 132 | 96 | 887 | 38 | 85 |
| Indiana............................ | 0 | 25 | 53 | 87 | 400 |
| Iowa................................. | 11 | 40 | 0 | 0 | 0 |
| Kansas.............................. | 0 | 39 | 0 | 100 | 114 |
| Kentucky.......................... | 41 | 4 | 163 | 61 | 69 |
| Louisiana......................... | 196 | 104 | 41 | 198 | 389 |
| Maine............................... | 0 | 14 | 0 | 0 | 0 |
| Maryland.......................... | 14 | 407 | 62 | 0 | 62 |
| Massachusets.................. | 122 | 22 | 49 | 112 | 11 |
| Michigan........................... | 0 | 66 | 0 | 426 | 97 |
| Minnesota......................... | 60 | 123 | 15 | 172 | 39 |
| Mississippi....................... | 0 | 20 | 0 | 149 | 84 |
| Missouri........................... | 0 | 204 | 41 | 61 | 235 |
| Montana........................... | 68 | 0 | 0 | 13 | 29 |
| Nebraska.......................... | 0 | 4 | 61 | 0 | 0 |
| Nevada............................. | 0 | 63 | 0 | 0 | 13 |
| New Hampshire................ | 5 | 22 | 0 | 15 | 108 |
| New Jersey...................... | 0 | 30 | 85 | 293 | 339 |
| New Mexico..................... | 0 | 20 | 65 | 0 | 17 |
| New York......................... | 0 | 314 | 342 | 174 | 343 |
| North Carolina................ | 0 | 73 | 22 | 9 | 280 |
| North Dakota.................. | 128 | 3 | 2 | 19 | 33 |

## Table 4.—Volume of New Issue Bonds for Selected Activities,[1] by State, 1984—Continued

[In millions of dollars]

| State | Type of activity | | | | |
|---|---|---|---|---|---|
| | Student loan bonds | Multi-family housing | Airport and dock, etc. | Sewage and waste disposal | Pollution control |
| Ohio | 0 | 64 | 29 | 42 | 220 |
| Oklahoma | 0 | 112 | 3 | 128 | 0 |
| Oregon | 0 | 0 | 26 | 57 | 3 |
| Pennsylvania | 200 | 53 | 25 | 606 | 571 |
| Rhode Island | 0 | 33 | 17 | 210 | 0 |
| South Carolina | 0 | 36 | 5 | 261 | 227 |
| South Dakota | 49 | 0 | 0 | 0 | 0 |
| Tennessee | 0 | 215 | 234 | 0 | 3 |
| Texas | 25 | 402 | 476 | 334 | 881 |
| Utah | 0 | 52 | 0 | 90 | 155 |
| Vermont | 0 | 0 | 0 | 1 | 0 |
| Virginia | 88 | 287 | 68 | 234 | 39 |
| Washington | 46 | 122 | 85 | 50 | 27 |
| West Virginia | 0 | 26 | 0 | 0 | 25 |
| Wisconsin | 20 | 10 | 0 | 2 | 23 |
| Wyoming | 0 | 0 | 0 | 0 | 319 |
| Others | 0 | 26 | 0 | 41 | 0 |

[1] Volume for new issues is the purchase price of the bond minus the amount used to refund earlier obligations.

Source: Office of the Secretary of the Treasury.

*Use of small-issue IDBs by State*

Table 5 sets forth the volume of small-issue IDBs for 1983 and 1984, by State. The table indicates that the volume of small-issue IDBs varies significantly from State to State. For example, for 1984, Pennsylvania issued $1.480 billion of small-issue IDBs while Hawaii issued no such bonds.

**Table 5.—Volume of Small-Issue IDBs Issued, by State, 1983–1984**

[In millions of dollars]

| State | 1983 | 1984 |
|---|---|---|
| United States, total | 13,879 | 16,949 |
| Alabama | 260 | 365 |
| Alaska | 159 | 89 |
| Arizona | 285 | 318 |
| Arkansas | 155 | 102 |
| California | 382 | 492 |
| Colorado | 212 | 218 |
| Connecticut | 119 | 203 |
| Delaware | 77 | 134 |
| Florida | 512 | 541 |
| Georgia | 505 | 745 |
| Hawaii | 0 | 0 |
| Idaho | 8 | 18 |
| Illinois | 579 | 728 |
| Indiana | 380 | 359 |
| Iowa | 211 | 186 |
| Kansas | 183 | 178 |
| Kentucky | 173 | 218 |
| Louisiana | 380 | 406 |
| Maine | 40 | 60 |
| Maryland | 322 | 561 |
| Massachusetts | 362 | 503 |
| Michigan | 273 | 631 |
| Minnesota | 565 | 585 |
| Mississippi | 108 | 111 |
| Missouri | 577 | 383 |
| Montana | 81 | 59 |
| Nebraska | 98 | 110 |
| Nevada | 26 | 21 |
| New Hampshire | 61 | 90 |
| New Jersey | 810 | 1,009 |
| New Mexico | 94 | 59 |
| New York | 574 | 1,149 |

### Table 5.—Volume of Small-Issue IDBs Issued, by State, 1983-1984—Continued

[In millions of dollars]

| State | 1983 | 1984 |
|---|---|---|
| North Carolina | 177 | 349 |
| North Dakota | 56 | 20 |
| Ohio | 645 | 661 |
| Oklahoma | 106 | 116 |
| Oregon | 37 | 78 |
| Pennsylvania | 1,231 | 1,480 |
| Rhode Island | 67 | 60 |
| South Carolina | 178 | 301 |
| South Dakota | 23 | 42 |
| Tennessee | 677 | 679 |
| Texas | 786 | 969 |
| Utah | 155 | 165 |
| Vermont | 13 | 72 |
| Virginia | 691 | 996 |
| Washington | 80 | 100 |
| West Virginia | 133 | 80 |
| Wisconsin | 231 | 309 |
| Wyoming | 22 | 45 |

Source: Office of the Secretary of the Treasury.

### *State volume limitations for private activity bonds*

Since 1983, the issuance of private activity bonds[1] (i.e., most IDBs[2] and student loan bonds) has been subject to State volume limitations. The applicable limitations are equal to the greater of $150 per resident of the State or $200 million. Table 6 shows the applicable private State activity bond volume limitations for 1984.

**Table 6.—1984 State Volume Limits on Tax-Exempt Student Loan Bonds and Certain IDBs**

[In thousands of dollars]

| State | 1984 volume limit[1] |
|---|---|
| United States, total | 36,561,775 |
| Alabama | 591,450 |
| Alaska | 200,000 |
| Arizona | 499,170 |
| Arkansas | 343,650 |
| California | 3,708,600 |
| Colorado | 456,750 |
| Connecticut | 472,950 |
| D.C. | 200,000 |
| Delaware | 200,000 |
| Florida | 1,562,400 |
| Georgia | 845,850 |
| Hawaii | 200,000 |
| Idaho | 200,000 |
| Illinois | 1,717,200 |
| Indiana | 820,650 |
| Iowa | 435,750 |
| Kansas | 361,200 |
| Kentucky | 550,050 |
| Louisiana | 654,300 |
| Maine | 200,000 |
| Maryland | 639,750 |
| Massachusetts | 867,150 |
| Michigan | 1,366,350 |

[1] IDBs for multifamily residential rental property and certain governmentally owned convention, trade show, and transportation property (including airports) are not subject to these volume limitations.

[2] The term private activity bond is defined more narrowly for purposes of the State volume limitations than for the information reporting requirement, discussed in II.D., above. Under the information reporting requirement, the term includes all IDBs, student loan bonds, and bonds for section 501(c)(3) organizations.

Table 6.—1984 State Volume Limits on Tax-Exempt Student Loan Bonds and Certain IDBs—Continued

[In thousands of dollars]

| State | 1984 volume limit[1] |
|---|---|
| Minnesota | 619,950 |
| Mississippi | 382,650 |
| Missouri | 742,650 |
| Montana | 200,000 |
| Nebraska | 237,900 |
| Nevada | 200,000 |
| New Hampshire | 200,000 |
| New Jersey | 1,115,700 |
| New Mexico | 203,850 |
| New York | 2,648,850 |
| North Carolina | 902,850 |
| North Dakota | 200,000 |
| Ohio | 1,618,650 |
| Oklahoma | 476,550 |
| Oregon | 397,350 |
| Pennsylvania | 1,779,750 |
| Rhode Island | 200,000 |
| South Carolina | 480,450 |
| South Dakota | 200,000 |
| Tennessee | 697,650 |
| Texas | 2,292,000 |
| Utah | 253,220 |
| Vermont | 200,000 |
| Virginia | 830,500 |
| Washington | 636,750 |
| West Virginia | 292,200 |
| Wisconsin | 714,750 |
| Wyoming | 200,000 |
| Puerto Rico | 487,650 |
| Virgin Island | 14,910 |
| American Samoa | 4,950 |
| Guam | 16,485 |
| Trust Territory of the Pacific | 17,745 |
| Northern Mariana Islands | 2,595 |

[1] The State volume limit equals the greater of $200 million or $150 per capita. Three States (Arizona, Utah, and Virginia) had additional transitional volume equal to one-half the difference between the annualized volume and the $150 per capita amount in 1984.

Source: Internal Revenue Service.

### *Nature of the subsidy provided by tax-exempt financing*

Table 7 sets forth the ratio of the average interest rates on long-term tax-exempt bonds to the average interest rate on taxable obligations for selected years. The ratio provides a measure of the depth of the subsidy provided by tax-exempt financing. Together with the marginal tax bracket of the average investor in tax-exempt bonds, the ratio also provides a measure of the efficiency of tax-exempt financing as a means of subsidizing eligible activities. In general, as the yield on tax-exempt obligations more closely approaches that on taxable obligations, a higher portion of the subsidy flows to the investor in tax-exempt obligations (in the form of increased after-tax yields) rather than to the eligible activity (in the form of reduced borrowing costs). The table indicates that, in recent years, an increasingly larger portion of the subsidy for long-term tax-exempt bonds has benefitted the holders of the bonds in the form of increased after-tax yields.

**Table 7.—Comparison of Yields on Taxable and Tax-Exempt Bonds, 1950–1984**

| Year | Average taxable yield [1] | Average tax-exempt bond yield [2] | Ratio of tax-exempt to taxable yield |
|---|---|---|---|
| 1950 | 2.86 | 1.90 | 0.664 |
| 1955 | 3.25 | 2.49 | .766 |
| 1960 | 4.73 | 3.51 | .742 |
| 1965 | 4.64 | 3.28 | .707 |
| 1970 | 8.51 | 6.34 | .745 |
| 1975 | 9.57 | 7.05 | .737 |
| 1976 | 9.01 | 6.64 | .737 |
| 1977 | 8.43 | 5.68 | .674 |
| 1978 | 9.07 | 6.03 | .665 |
| 1979 | 10.12 | 6.52 | .644 |
| 1980 | 12.75 | 8.59 | .674 |
| 1981 | 15.06 | 11.33 | .752 |
| 1982 | 14.94 | 11.66 | .780 |
| 1983 | 12.78 | 9.51 | .744 |
| 1984 | 13.49 | 10.10 | .749 |

[1] Moody's Investor Service's selected long-term bonds.

[2] Bond Buyer's 20 bond index.

Source: Board of Governors of the Federal Reserve System, selected issues of *Federal Reserve Bulletin;* and U.S. Department of Commerce, Bureau of Economic Analysis, *1973 Statistical Supplement to the Survey of Current Business.*

### *Tax-exempt yields as a percent of taxable yields, 1970–1984*

Another method that is helpful in determining the subsidy provided by tax-exempt financing is to examine the total present value of the reduced after-tax interest payments over the life of the bonds as a percentage of the principal amount of the bonds. If the principal amount of the bonds is equal to the cost of the facilities financed, the value of the reduced after-tax interest payments is equivalent to the amount of the cost of the facilities financed by the subsidy. (This may also be thought of as an effective tax credit equal to the present value of that amount.) That present value varies with the average time the bonds are outstanding, the difference in interest rates resulting from tax-exemption, and the marginal tax rate of the borrower. The borrower's marginal tax rate is relevant to the value of the subsidy because borrowers are able to deduct interest payments for Federal income tax purposes whether the interest is taxable or tax-exempt to the lender.

Table 9 sets forth the percentage values of tax-exemption for various differences in interest rates and average duration of bonds. The amounts in the table are the present value of the interest savings from tax-exempt financing expressed as a percentage of the amount of the loan. For example, if bonds have an average maturity of 15 years, a tax-exempt interest rate 3 points lower than the comparable taxable rate, the subsidy provided by tax-exempt financing is equivalent to a payment of 11.4 percent of the costs of the facility being financed.

The table assumes that the borrower is in a 50-percent marginal tax bracket. If the marginal tax rate is lower than 50 percent (as is typically the case with mortgage subsidy bonds or student loan bonds), the value of the subsidy would be increased proportionately (e.g., the values for a borrower in a 30-percent marginal tax bracket would be 40 percent higher). (Tax-exemption typically has resulted in reduced interest rates of from 2 to 4 percentage points, with the average being approximately 3 percentage points in recent years.)

**Table 8.—Present Value of Tax-Exempt Financing Expressed as a Percentage of the Amount of the Bonds**

| | Difference in interest rate | | |
|---|---|---|---|
| | 2 percentage points | 3 percentage points | 4 percentage points |
| Average life of bonds: | | | |
| 5 years | 3.8 | 5.7 | 7.6 |
| 15 years | 7.6 | 11.4 | 15.2 |
| 30 years | 9.4 | 14.1 | 18.9 |

Source: Joint Committee on Taxation.

### *Ownership of tax-exempt bonds*

Tables 9 and 10 present statistics on the major owners of tax-exempt bonds, by dollar amount and as a percentage of total bonds outstanding. During the period 1972 through 1984, the percentage of State and local government bonds held by banks and thrift institutions decreased from 51.1 percent to 32.1 percent. During this same period, holdings by mutual funds increased from 27.4 percent to 38.1 percent. Private households held between 25.0 percent (in 1978) and 38.1 percent (in 1984) of the total bonds outstanding during this period.

## Table 9.—Ownership of Tax-Exempt State-Local Bonds by Class of Holder, 1972–1984 [1] Volume

[In millions of dollars]

| Class of holder | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Households | 48,373 | 53,658 | 61,860 | 68,061 | 70,070 | 70,148 | 72,738 | 82,719 | 89,879 | 100,810 | 132,803 | 173,831 | 205,308 |
| Nonfinancial corporate business | 4,175 | 4,038 | 4,654 | 4,481 | 3,419 | 3,468 | 3,658 | 3,687 | 3,490 | 3,470 | 3,536 | 4,201 | 4,066 |
| State and local governments | 1,833 | 2,062 | 2,586 | 4,969 | 7,341 | 7,920 | 7,238 | 6,788 | 7,008 | 7,139 | 8,718 | 9,521 | 9,954 |
| Commercial banks, | 89,960 | 95,656 | 101,148 | 102,927 | 105,976 | 115,155 | 126,205 | 135,583 | 149,199 | 154,174 | 158,690 | 162,540 | 171,961 |
| Savings and loan associations | 165 | 185 | 500 | 1,508 | 1,225 | 1,200 | 1,275 | 1,150 | 1,190 | 1,305 | 838 | 907 | 920 |
| Mutual savings banks | 873 | 921 | 930 | 1,545 | 2,417 | 2,828 | 3,335 | 2,930 | 2,390 | 2,288 | 2,470 | 2,177 | 2,075 |
| Mutual funds | 0 | 0 | 0 | 0 | 525 | 2,156 | 2,684 | 4,040 | 6,357 | 9,278 | 21,130 | 31,451 | 44,847 |
| Life insurance companies | 3,367 | 3,412 | 3,667 | 4,508 | 5,594 | 6,051 | 6,402 | 6,428 | 6,701 | 7,151 | 9,047 | 9,986 | 9,425 |
| State and local government retirement funds | 2,029 | 1,691 | 983 | 1,940 | 3,360 | 3,544 | 3,951 | 3,910 | 4,059 | 3,856 | 3,131 | 1,957 | 1,500 |
| Other insurance companies | 24,820 | 28,462 | 30,662 | 33,273 | 38,679 | 49,390 | 62,931 | 72,811 | 80,533 | 83,923 | 86,968 | 86,667 | 87,193 |
| Brokers and dealers | 912 | 1,130 | 705 | 631 | 901 | 1,065 | 864 | 1,046 | 1,064 | 1,220 | 1,047 | 1,400 | 2,000 |
| Total | 176,507 | 191,215 | 207,695 | 223,843 | 239,507 | 262,925 | 291,281 | 321,092 | 351,870 | 374,614 | 428,378 | 484,638 | 539,249 |

[1] Ownership is as of the end of the calendar year.

Note.—Details may not add to totals because of rounding.

Source: Board of Governors of the Federal Reserve System, unpublished data.

### Table 10.—Ownership of Tax-Exempt State-Local Bonds by Class of Holder, 1972–1984 [1] Percent

| Class of holder | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Households | 27.4 | 28.1 | 29.8 | 30.4 | 29.3 | 26.7 | 25.0 | 25.8 | 25.5 | 26.9 | 31.0 | 35.9 | 38.1 |
| Nonfinancial corporate business | 2.4 | 2.1 | 2.2 | 2.0 | 1.4 | 1.3 | 1.3 | 1.1 | 1.0 | .9 | .8 | 0.9 | 0.8 |
| State and local governments | 1.0 | 1.1 | 1.2 | 2.2 | 3.1 | 3.0 | 2.5 | 2.1 | 2.0 | 1.9 | 2.0 | 2.0 | 1.8 |
| Commercial banks | 51.0 | 50.0 | 48.7 | 46.0 | 44.2 | 43.8 | 43.3 | 42.2 | 42.4 | 41.2 | 37.0 | 33.5 | 31.9 |
| Savings and loan associations | .1 | .1 | .2 | .7 | .5 | .5 | .4 | .4 | .3 | .3 | .2 | .2 | .2 |
| Mutual savings banks | .5 | .5 | .4 | .7 | 1.0 | 1.1 | 1.1 | .9 | .7 | .6 | .6 | .4 | .4 |
| Mutual funds | 0 | 0 | 0 | 0 | .2 | .8 | .9 | 1.3 | 1.8 | 2.5 | 4.9 | 6.5 | 8.3 |
| Life insurance companies | 1.9 | 1.8 | 1.8 | 2.0 | 2.3 | 2.3 | 2.2 | 2.0 | 1.9 | 1.9 | 2.1 | 2.1 | 1.7 |
| State and local government retirement funds | 1.1 | .9 | .5 | .9 | 1.4 | 1.3 | 1.4 | 1.2 | 1.2 | .0 | .7 | .4 | .3 |
| Other insurance companies | 14.1 | 14.9 | 14.8 | 14.9 | 16.1 | 18.8 | 21.6 | 22.7 | 22.9 | 22.4 | 20.3 | 17.9 | 16.2 |
| Brokers and dealers | .5 | .6 | .3 | .3 | .4 | .4 | .3 | .3 | .3 | .3 | .2 | .3 | .4 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

[1] Ownership is as of the end of the calendar year.

Note.—Details may not add to totals because of rounding.

Source: Board of Governors of the Federal Reserve System, unpublished data.

## B. Statistical Data Relating to Mortgage Subsidy Bonds

### *Volume of mortgage subsidy bonds*

The volume of mortgage subsidy bonds for the period 1980 through 1984 is shown in Table 11. State and local governments issued a total of $12.8 billion of qualified mortgage bonds (i.e., single-family mortgage bonds other than veterans' mortgage bonds) in 1984, or approximately 11 percent of total State and local government borrowing. By contrast, in 1980, the volume of qualified mortgage bonds was $10.5 billion (19.3 percent of State and local government borrowing), while for 1981 (a comparatively depressed year for the housing industry) the volume was $2.8 billion (5.1 percent).

Since 1984 only five States are authorized to issue qualified veterans' mortgage bonds. These five States are the only States that have issued such bonds historically. Table 12 shows the volume of veterans' mortgage bonds issued during the period 1980 through 1984. In 1983 and 1984, States issued approximately $600 million per year of qualified veterans' mortgage bonds, or approximately 0.65 percent of total State and local government borrowing.

**Table 11.—Volume of Qualified Mortgage Bonds Issued, by State, 1980–1984**

[In millions of dollars]

| State | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|
| United States, total | 10,821 | 3,673 | 8,627 | 10,982 | 12,758 |
| Alabama | 150 | 100 | 200 | 200 | 198 |
| Alaska | 460 | 200 | 235 | 200 | 200 |
| Arizona | 133 | 0 | 192 | 114 | 105 |
| Arkansas | 196 | 47 | 100 | 200 | 107 |
| California | 1,601 | 446 | 1,865 | 1,429 | 2,193 |
| Colorado | 473 | 135 | 163 | 228 | 241 |
| Connecticut | 178 | 200 | 200 | 200 | 200 |
| Delaware | 191 | 0 | 40 | 39 | 75 |
| D.C. | 0 | 0 | 57 | 0 | 100 |
| Florida | 612 | 475 | 406 | 544 | 597 |
| Georgia | 115 | 0 | 157 | 56 | 186 |
| Hawaii | 150 | 20 | 60 | 141 | 100 |
| Idaho | 56 | 30 | 4 | 90 | 56 |
| Illinois | 52 | 20 | 191 | 261 | 432 |
| Indiana | 150 | 0 | 75 | 200 | 200 |
| Iowa | 0 | 0 | 14 | 36 | 200 |
| Kansas | 433 | 356 | 146 | 141 | 201 |

### Table 11.—Volume of Qualified Mortgage Bonds Issued, by State, 1980-1984—Continued

[In millions of dollars]

| State | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|
| Kentucky | 55 | 36 | 31 | 181 | 200 |
| Louisiana | 496 | 350 | 149 | 190 | 200 |
| Maine | 70 | 0 | 54 | 122 | 91 |
| Maryland | 210 | 141 | 281 | 198 | 256 |
| Massachusetts | 75 | 0 | 200 | 214 | 237 |
| Michigan | 114 | 25 | 30 | 200 | 145 |
| Minnesota | 326 | 201 | 218 | 172 | 280 |
| Mississippi | 150 | 0 | 151 | 127 | 200 |
| Missouri | 133 | 0 | 200 | 200 | 211 |
| Montana | 50 | 0 | 55 | 200 | 75 |
| Nebraska | 200 | 0 | 137 | 200 | 180 |
| Nevada | 30 | 0 | 60 | 98 | 200 |
| New Hampshire | 60 | 0 | 167 | 60 | 50 |
| New Jersey | 130 | 15 | 275 | 171 | 332 |
| New Mexico | 75 | 20 | 118 | 80 | 106 |
| New York | 125 | 105 | 402 | 376 | 445 |
| North Carolina | 58 | 55 | 0 | 186 | 110 |
| North Dakota | 0 | 0 | 29 | 120 | 73 |
| Ohio | 0 | 0 | 0 | 410 | 335 |
| Oklahoma | 739 | 100 | 25 | 200 | 200 |
| Oregon | 165 | 0 | 125 | 15 | 0 |
| Pennsylvania | 23 | 85 | 266 | 280 | 293 |
| Rhode Island | 149 | 65 | 72 | 190 | 200 |
| South Carolina | 0 | 0 | 83 | 100 | 80 |
| South Dakota | 162 | 0 | 24 | 200 | 200 |
| Tennessee | 350 | 50 | 150 | 197 | 200 |
| Texas | 1,076 | 156 | 622 | 801 | 1,015 |
| Utah | 150 | 0 | 122 | 198 | 198 |
| Vermont | 75 | 0 | 35 | 58 | 48 |
| Virginia | 121 | 100 | 266 | 238 | 366 |
| Washington | 0 | 0 | 0 | 199 | 175 |
| West Virginia | 229 | 0 | 25 | 87 | 201 |
| Wisconsin | 125 | 20 | 150 | 185 | 191 |
| Wyoming | 150 | 75 | 0 | 200 | 74 |
| Puerto Rico | 0 | 0 | 0 | 250 | 200 |

Source: Office of Financial Management, U.S. Department of Housing and Urban Development, unpublished data and Office of the Secretary of the Treasury.

### Table 12.—Volume of Veterans' Mortgage Bonds Issued, by State, 1980–1984

[In millions of dollars]

| State | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|
| Alaska | 0 | 0 | 0 | 475 | 632 |
| California | 652 | 250 | 150 | 250 | 710 |
| Oregon | 900 | 620 | 300 | 0 | 131 |
| Texas | 0 | 0 | 0 | 0 | 500 |
| Wisconsin | 0 | 0 | 30 | 20 | 50 |
| Total | 1,552 | 870 | 480 | 745 | 1,992 |

Note.—The amounts listed are for tax-exempt general obligation bonds issued only for mortgage loans to veterans. Therefore, the data does not include revenue bonds issued for the purchase of land only or issued primarily for other purposes. These issues are included in other classifications, such as IDBs.

Source: Joint Committee on Taxation.

### *State volume limitations*

Issuance of qualified mortgage bonds and qualified veterans' mortgage bonds is subject to separate annual State volume limitations. The qualified mortgage bond volume limitation is equal to the greater of (1) 9 percent of average mortgage originations for single-family owner-occupied residences in the State during the preceding 3 years, or (2) $200 million. Table 13 shows the 1984 qualified mortgage bond volume limitation applicable to each State.

Qualified veterans' mortgage bonds may be issued only by States that issued such bonds before June 22, 1984, and the annual volume of these bonds is limited by reference to issuances during the period 1979 through June 22, 1984. Table 14 shows the applicable State volume limitations for qualified veterans' mortgage bonds.

### Table 13.—1984 State Volume Limitations for Qualified Mortgage Bonds

[In millions of dollars]

| State | Safe harbor ceiling |
|---|---|
| United States, total | 14,454 |
| Alabama | 200 |
| Alaska | 200 |
| Arizona | 211 |
| Arkansas | 200 |
| California | 1,756 |
| Colorado | 294 |
| Connecticut | 200 |

## Table 13.—1984 State Volume Limitations for Qualified Mortgage Bonds—Continued

[In millions of dollars]

| State | Safe harbor ceiling |
|---|---|
| Delaware | 200 |
| D.C. | 200 |
| Florida | 597 |
| Georgia | 200 |
| Hawaii | 200 |
| Idaho | 200 |
| Illinois | 432 |
| Indiana | 200 |
| Iowa | 200 |
| Kansas | 200 |
| Kentucky | 200 |
| Louisiana | 200 |
| Maine | 200 |
| Maryland | 265 |
| Massachusetts | 200 |
| Michigan | 234 |
| Minnesota | 200 |
| Mississippi | 200 |
| Missouri | 200 |
| Montana | 200 |
| Nebraska | 200 |
| Nevada | 200 |
| New Hampshire | 200 |
| New Jersey | 331 |
| New Mexico | 200 |
| New York | 445 |
| North Carolina | 202 |
| North Dakota | 200 |
| Ohio | 346 |
| Oklahoma | 200 |
| Oregon | 200 |
| Pennsylvania | 347 |
| Rhode Island | 200 |
| South Carolina | 200 |
| South Dakota | 200 |
| Tennessee | 200 |
| Texas | 1,014 |
| Utah | 200 |
| Vermont | 200 |
| Virginia | 365 |
| Washington | 215 |
| West Virginia | 200 |
| Wisconsin | 200 |
| Wyoming | 200 |
| Puerto Rico | 200 |

Source: Internal Revenue Service.

## Table 14.—1984 State Volume Limitations for Qualified Veterans' Mortgage Bonds

[In millions of dollars]

| State | Volume limitation |
|---|---|
| Alaska | 302 |
| California | 340 |
| Oregon | 584 |
| Texas | 250 |
| Wisconsin | 72 |

Source: Joint Committee on Taxation.

### *Effect of volume limitations*

The effect of the State volume limitations on qualified mortgage bonds is illustrated by the data provided in Table 15. Note that, in 1984, the $200 million limit was greater than 9 percent of average mortgage activity in 36 states (and Puerto Rico). Also, in 1984, the State volume limitations varied between 75.2 percent of total mortgage originations for Vermont to 4.7 percent for New York.

**Table 15.—Comparison of Statutory State Volume Limitations for Qualified Mortgage Bonds and Total Mortgage Originations, by State, 1984**

[In millions of dollars]

| | State volume limitations | Total mortgage originations | State volume limitations as a percent of total mortgage originations |
|---|---|---|---|
| United States, total..... | 14,454 | 169,311 | 8.5 |
| Alabama........................ | 200 | 1,498 | 13.4 |
| Alaska.......................... | 200 | 702 | 28.5 |
| Arizona......................... | 211 | 3,564 | 5.9 |
| Arkansas....................... | 200 | 1,095 | 18.3 |
| California...................... | 1,756 | 36,276 | 4.8 |
| Colorado........................ | 294 | 4,899 | 6.0 |
| Connecticut.................. | 200 | 2,909 | 6.9 |
| Delaware....................... | 200 | 350 | 57.1 |
| D.C.............................. | 200 | 560 | 35.7 |
| Florida.......................... | 597 | 9,791 | 6.1 |
| Georgia......................... | 200 | 3,572 | 5.6 |
| Hawaii.......................... | 200 | 1,265 | 15.8 |
| Idaho............................ | 200 | 376 | 53.2 |
| Illinois.......................... | 432 | 6,105 | 7.1 |
| Indiana......................... | 200 | 2,338 | 8.6 |
| Iowa............................. | 200 | 926 | 21.6 |
| Kansas.......................... | 200 | 1,294 | 15.5 |
| Kentucky...................... | 200 | 1,124 | 17.8 |
| Louisiana...................... | 200 | 2,205 | 9.1 |
| Maine........................... | 200 | 588 | 34.0 |
| Maryland...................... | 265 | 4,564 | 5.8 |
| Massachusetts.............. | 200 | 3,886 | 5.1 |
| Michigan....................... | 234 | 3,358 | 7.0 |
| Minnesota..................... | 200 | 2,277 | 8.8 |
| Mississippi.................... | 200 | 1,168 | 17.1 |

Table 15.—Comparison of Statutory State Volume Limitations for Qualified Mortgage Bonds and Total Mortgage Originations, by State, 1984—Continued

[In millions of dollars]

| | State volume limitations | Total mortgage originations | State volume limitations as a percent of total mortgage originations |
|---|---|---|---|
| Missouri | 200 | 2,553 | 7.8 |
| Montana | 200 | 460 | 43.5 |
| Nebraska | 200 | 648 | 30.9 |
| Nevada | 200 | 1,130 | 17.7 |
| New Hampshire | 200 | 820 | 24.4 |
| New Jersey | 331 | 6,560 | 5.0 |
| New Mexico | 200 | 953 | 21.0 |
| New York | 445 | 9,431 | 4.7 |
| North Carolina | 202 | 3,233 | 6.2 |
| North Dakota | 200 | 338 | 59.2 |
| Ohio | 346 | 4,987 | 6.9 |
| Oklahoma | 200 | 1,938 | 10.3 |
| Oregon | 200 | 810 | 24.7 |
| Pennsylvania | 347 | 5,753 | 6.0 |
| Rhode Island | 200 | 443 | 45.1 |
| South Carolina | 200 | 1,566 | 12.8 |
| South Dakota | 200 | 283 | 70.7 |
| Tennessee | 200 | 2,331 | 8.6 |
| Texas | 1,014 | 13,373 | 7.6 |
| Utah | 200 | 1,324 | 15.1 |
| Vermont | 200 | 266 | 75.2 |
| Virginia | 365 | 6,378 | 5.7 |
| Washington | 215 | 3,287 | 6.5 |
| West Virginia | 200 | 561 | 35.7 |
| Wisconsin | 200 | 2,307 | 8.7 |
| Wyoming | 200 | 410 | 48.8 |
| Puerto Rico | 200 | 478 | 41.8 |

Source: Office of Financial Management, U.S. Department of Housing and Urban Development, and Internal Revenue Service.

*Purchase price levels*

Table 16 sets forth data that help evaluate the effect of the purchase price limitation on the residences eligible for financing with qualified mortgage bonds. Of homes sold to first-time buyers in 1983, approximately 83.8 percent (67.9 percent, by value) were sold for prices equal to less than 110 percent of the average national purchase price. Thus, it may be estimated that 83.8 percent or more of first time purchasers would have qualified under the average area purchase price limitations applicable to qualified mortgage bonds.

Table 17 shows the applicable price limitations for selected areas.

**Table 16.—Percent of Homes Sold to First-Time Purchasers at Less Than Selected Percentages of Average Purchase Prices in 1983**

| Percentage of average purchase price | 80 | 90 | 100 | 110 | 120 |
|---|---|---|---|---|---|
| Percent of homes measured by: | | | | | |
| Number | 55.8 | 67.5 | 75.8 | 83.8 | 88.3 |
| Value | 36.2 | 48.7 | 58.0 | 67.9 | 74.2 |

Source: Based on U.S. Department of Housing and Urban Development, Annual Housing Survey: 1979 (unpublished data) and Office of the Secretary of the Treasury.

**Table 17.—Average Purchase Price Safe Harbor Limitations for Single Family Residences for Selected Areas**

| State and area designation | Average area purchase price safe harbor limitations for single family residences | |
|---|---|---|
| | New residences | Existing residences |
| Alabama: | | |
| All areas | $72,400 | $59,100 |
| Arkansas: | | |
| All areas | 86,100 | 84,900 |
| California: | | |
| Bakersfield MSA | 110,400 | 107,000 |
| Oakland PMSA | 153,100 | 149,200 |
| Sacramento MSA | 92,800 | 109,200 |

Table 17.—Average Purchase Price Safe Harbor Limitations for Single Family Residences for Selected Areas—Continued

| State and area designation | Average area purchase price safe harbor limitations for single family residences | |
|---|---|---|
| | New residences | Existing residences |
| Colorado: | | |
| Boulder-Longmont PMSA | 114,900 | 124,700 |
| Connecticut: | | |
| Hartford PMSA | 82,800 | 94,500 |
| Delaware: | | |
| Wilmington (DE–NI–MD) | 75,900 | 58,400 |
| Florida: | | |
| Tampa-St. Petersburg-Clearwater MSA | 76,700 | 76,400 |
| Georgia: | | |
| Atlanta MSA | 100,000 | 95,100 |
| All other areas | 62,700 | 61,600 |
| Hawaii: | | |
| All areas | 137,300 | 124,600 |
| Idaho: | | |
| All areas | 88,300 | 78,300 |
| Illinois: | | |
| Chicago PMSA | 113,600 | 94,400 |
| Indiana: | | |
| All areas | 46,700 | 55,400 |
| Iowa: | | |
| All areas | 70,100 | 51,200 |
| Kansas: | | |
| Wichita MSA | 80,000 | 74,400 |
| Louisiana: | | |
| All areas | 83,700 | 93,400 |
| Maine: | | |
| All areas | 66,800 | 64,300 |
| Massachusetts: | | |
| Boston PMSA | 88,500 | 99,300 |
| Michigan: | | |
| Grand Rapids MSA | 66,900 | 67,900 |
| Minnesota: | | |
| Minneapolis-St. Paul (MN–WI) MSA | 91,800 | 99,700 |
| All other areas | 57,200 | 56,600 |
| Missouri: | | |
| St. Louis (MO–IL) PMSA | 84,600 | 71,400 |
| Montana: | | |
| All areas | 70,400 | 86,800 |
| Nebraska: | | |
| All areas | 106,000 | 68,100 |
| New Hampshire: | | |
| All areas | 77,300 | 78,400 |

Table 17.—Average Purchase Price Safe Harbor Limitations for Single Family Residences for Selected Areas—Continued

| State and area designation | Average area purchase price safe harbor limitations for single family residences | |
|---|---|---|
| | New residences | Existing residences |
| New Jersey: | | |
| Newark PSMA | 136,300 | 122,000 |
| All other areas | 87,300 | 89,300 |
| New York: | | |
| Nassau-Suffolk PMSA | 122,000 | 110,000 |
| New York PMSA | 121,200 | 123,400 |
| Rochester MSA | 81,100 | 73,400 |
| Syracuse MSA | 71,300 | 58,900 |
| All other areas | 59,000 | 48,200 |
| North Dakota: | | |
| All areas | 70,400 | 86,800 |
| Ohio: | | |
| Akron PMSA | 81,000 | 70,800 |
| Cincinnati (OH-KY-IN) PMSA | 101,500 | 83,500 |
| Oklahoma: | | |
| All areas | 70,000 | 73,600 |
| Oregon: | | |
| Portland PMSA | 85,600 | 81,300 |
| Pennsylvania: | | |
| Philadelphia (PA-NJ) MSA | 88,600 | 71,400 |
| Pittsburgh PMSA | 96,500 | 67,000 |
| Rhode Island: | | |
| Providence PMSA | 67,800 | 61,500 |
| South Carolina: | | |
| Greenville-Spartenburg MSA | 83,100 | 54,800 |
| Tennessee: | | |
| Nashville MSA | 79,300 | 78,600 |
| All other areas | 88,100 | 56,000 |
| Texas: | | |
| Austin MSA | 104,200 | 108,500 |
| Houston PMSA | 99,700 | 107,600 |
| Wyoming: | | |
| All areas | 70,400 | 86,800 |

Source: Internal Revenue Service.

### *First-time home-purchasers*

Table 18 shows the percentage of homebuyers each year that are first-time purchasers. For purposes of this table, the term "first-time purchaser" means an individual who has never before purchased a residence. (The three-year rule for determining first-time purchasers under the qualified mortgage bond rules would result in slightly higher percentages of persons being considered first-time purchasers.) From 1976 to 1983, the percentage of homes purchased by first-time purchasers varied from 44.8 percent in 1976 to 40.5 percent in 1983, with a mean of 39.95 percent.

**Table 18.—Percentage of Homes Purchased by First-Time Purchasers, 1976–1983**

| Year | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|---|---|
| Percentage........ | 44.8 | 48.1 | 36.7 | 36.6 | 32.9 | 39.4 | 40.6 | 40.5 |

Source: U.S. Department of Commerce, Bureau of the Census, *Statistical Abstract of the United States, 1985.*

## C. Revenue Effect

Table 19 indicates the estimated revenue cost ("tax expenditure") for private activity tax-exempt bonds during the next five fiscal years. For this purpose, private activity bonds include all IDBs, student loan bonds, mortgage subsidy bonds, and bonds for the benefit of charitable organizations (described in sec. 501 (c)(3)). The total fiscal year revenue cost for 1986 through 1990 from bonds to finance private activities is estimated at $68.5 billion. These estimates assume that the present law "sunsets" for qualified mortgage bonds (1987) and small-issue IDBs (1986 generally) remain in effect.

### Table 19.—Estimated Revenue Cost for Private Activity Bonds, Fiscal Years 1986–1990

[In billions of dollars]

| Type of bond | 1986 | 1987 | 1988 | 1989 | 1990 | 1986–90 |
|---|---|---|---|---|---|---|
| Total private activity bonds | 11.0 | 12.4 | 13.9 | 15.1 | 16.1 | 68.5 |
| Exempt organization bonds | 2.1 | 2.5 | 2.9 | 3.3 | 3.8 | 14.6 |
| Exempt activity IDBs: | | | | | | |
| Pollution control bonds | 1.1 | 1.2 | 1.3 | 1.4 | 1.6 | 6.6 |
| Airport, dock, etc. bonds | 0.5 | 0.5 | 0.6 | 0.7 | 0.8 | 3.1 |
| Solid waste facility bonds | 0.3 | 0.3 | 0.3 | 0.4 | 0.4 | 1.7 |
| Energy production facility bonds | 0.2 | 0.2 | 0.2 | 0.2 | 0.3 | 1.1 |
| Mass transit bonds | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.5 |
| Multifamily residential rental housing | 1.0 | 1.2 | 1.4 | 1.7 | 1.9 | 7.2 |
| Student loan bonds | 0.4 | 0.5 | 0.5 | 0.6 | 0.6 | 2.6 |
| Mortgage subsidy bonds: | | | | | | |
| Qualified mortgage bonds | 2.2 | 2.5 | 2.8 | 2.8 | 2.6 | 12.9 |

Table 19.—Estimated Revenue Cost for Private Activity Bonds, Fiscal Years 1986–1990—Continued

[In billions of dollars]

| Type of bond | 1986 | 1987 | 1988 | 1989 | 1990 | 1986–90 |
|---|---|---|---|---|---|---|
| Veterans' mortgage bonds | 0.3 | 0.3 | 0.4 | 0.4 | 0.4 | 1.8 |
| Small-issue IDBs | 2.8 | 3.0 | 3.3 | 3.5 | 3.5 | 16.1 |

Source: Joint Committee on Taxation.

Revenue effects of tax-exempt bonds traditionally have been expressed as the revenue foregone on a year-by-year basis as a result of the issuance of the bonds. However, tax-exempt bonds typically are outstanding for a number of years, and consequently, the issuance of tax-exempt bonds during a year results in revenue losses over a number of years.

Since tax-exempt bonds result in tax expenditures over a number of years, it is helpful to express the revenue effect of these obligations in terms of the total value of future revenue losses. Table 20 indicates projected future revenue losses from bonds forecast to be issued in calendar year 1985. For example, the $6.9 billion of bonds for multifamily residential rental property forecast to be issued in calendar year 1985 is estimated to result in total future revenue losses of $2.9 billion, with a present value of $1.6 billion. Similarly, the $11.2 billion of small-issue IDBs forecast to be issued in 1985 is estimated to result in total future revenue losses of $5.5 billion, with a present value of $2.9 billion.

Table 20.—Various Measures of Total Revenue Cost of Private Activity Tax-Exempt Bonds Issued in 1985

[In billions of dollars]

| Type of bond | Dollar amount of estimated 1985 bond issues | Total revenue loss attributable to bonds issued in 1985 | Present value of total in year of issue |
|---|---|---|---|
| Exempt organization bonds | 10.8 | 7.8 | 3.6 |
| Exempt activity bonds: | | | |
| Pollution control bonds | 3.7 | 2.4 | 1.1 |
| Airport, dock, etc. bonds | 1.9 | 1.2 | .6 |
| Solid waste facility bonds | 1.1 | .7 | .3 |
| Energy production facility bonds | .8 | .5 | .2 |
| Multifamily residential rental property bonds | 6.9 | 2.9 | 1.6 |
| Student loan bonds | 2.8 | .7 | .5 |

Table 20.—Various Measures of Total Revenue Cost of Private Activity Tax-Exempt Bonds Issued in 1985—Continued

[In billions of dollars]

| Type of bond | Dollar amount of estimated 1985 bond issues | Total revenue loss attributable to bonds issued in 1985 | Present value of total in year of issue |
|---|---|---|---|
| Mortgage subsidy bonds: | | | |
| Qualified mortgage bonds | 12.5 | 5.1 | 3.0 |
| Veterans' mortgage bonds | 1.5 | .6 | .4 |
| Small-issue IDBs | 11.2 | 5.5 | 2.9 |

Source: Joint Committee on Taxation.

Senator CHAFEE. We will continue today the public hearing on the impact of the tax-reform measures, and this morning we are concentrating on tax-exempt bonds.

The first panel will consist of Mr. John T. Walsh, Mr. Jean Rousseau, and Mr. Roger Feldman. If you folks would come forward?

[Pause.]

The CHAIRMAN. Please go right ahead. Your statements in their entirety will be in the record. We ask you to hold yourselves to our 5-minute committee limit.

## STATEMENT OF CATHERINE L. SPAIN, DIRECTOR, FEDERAL LIAISON CENTER OF THE GOVERNMENT FINANCE OFFICERS ASSOCIATION, WASHINGTON, DC, FOR MR. JOHN WALSH

Ms. SPAIN. Thank you, Senators.

My name is Cathy Spain. I am the director of the Federal Liaison Center of the Government Finance Officers Association. Mr. Walsh's plane had mechanical difficulty this morning, and he will not be able to be with us, unfortunately.

The CHAIRMAN. Give me your name again.

Ms. SPAIN. It is Catherine L. Spain, like the country.

The CHAIRMAN. OK.

Ms. SPAIN. Believe me, I am no substitute for Mr. Walsh, who has spent 44 years in Government finance.

Our association is a professional association of State and local finance directors, budget directors, controllers, and treasurers, and for 33 years our association has taken a policy position that supports restrictions in the use of tax-exempt bonds that are solely for the benefit of private industry.

As responsible finance officers, we are very concerned about ever-increasing Federal deficits; however, our primary concern is with the proliferation in the use of tax-exempt bonds and the impact that these have on interest rates paid for bonds that are used to finance roads, schools, sewers, water systems, and other governmental facilities.

While we support restrictions, we oppose the administration's proposal on tax-exempt bonds. We do not believe that they are reforms. We believe that the administration's proposals are an assault on tax-exempt bonds and, as such, have been opposed by every major national organization representing State and local issuers of tax-exempt bonds.

The administration's plan not only affects the so-called private purpose bonds but also general obligation and revenue bonds issued for governmental services and facilities, including those that are now technically classified as industrial development bonds which finance such projects as solid waste disposal, sewer and water systems, and airports, docks, and wharves.

I would also like to note that the leading proposals here in the Congress also affect these public-purpose bonds that are technically industrial development bonds.

The administration's plan, in our view, substitutes restrictions that are more burdensome and complex than the present law. And specifically, GFOA and other public interest groups oppose the redefinition of governmental bonds which relies on an arbitrary 1-percent rule. This will affect indisputable governmental purposes.

The elimination of the deduction taken by banks and other financial institutions for the costs of buying and carrying tax-exempt bonds is also opposed by our association and other public groups. We believe that many jurisdictions that rely on local institutions for their capital financing will be hurt by this provision.

We believe that the denial of tax-exempt financing, if a long-term management contract exists, is wrong. This is a very frequent type of activity that occurs in State and local government, and frequently, for example, many sewage treatment plants are managed this way.

The penalties the plan imposes on State and local officials who practice good cash management and good debt management are also bothersome. Arbitrage, when not abused, reduces the amount of bonds issued for a project, and advanced refundings permit issuers to refinance their debt when interest rates decline.

We have taken the position that if there are abuses in this area, they ought to be identified and solutions ought to be targeted.

We are also opposed to the adoption of a new Federal reporting requirement that will be costly and burdensome on State and local officials and that many believe to be unconstitutional.

As an association, we are very concerned about the disruption of the tax-exempt market as issuers feel that they must rush to market in anticipation of retroactive effective dates for bond provisions.

We support prospective legislation, at a minimum.

We believe, in terms of the cost impacts, that the bank provisions alone could add more than $1 billion annually to State and local borrowing costs. The proposed arbitrage changes are anticipated to increase project costs by 2 to 7 percent, and the advance refunding changes could be millions in savings for individual State and local governments.

Senators, in a similar vein, we are very concerned about minimum tax proposals. A minimum tax proposal was offered in 1982 and defeated on the grounds that the Federal Government is barred by the Constitution from taxing State and local governments' interest on their securities.

In conclusion, in our comments about the administration's proposal, we endorse the sentiments of the treasurer of New Jersey, who said yesterday that a tax plan that shifts higher costs to State and local governments is not revenue neutral.

Now, since there is a substantial chance that a tax bill may be adopted that would include provisions related to tax-exempt bonds, the Government Finance Officers Association is recommending an alternative to the administration's plan. It is our intent to preserve the tax-exempt status of governmental tax-supported general-obligation and revenue bonds that are used to finance such projects as schools, roads, bridges, tunnels, and airports, by establishing a three-part test for public purpose described below.

We also want to clarify that certain bonds that are currently classified as industrial development bonds because of the involvement of the private sector with these facilities should also pass our three-part test and continue to have unchallenged tax-exempt financing.

We support an exception to our test that would allow bonds to continue to be used in areas of severe economic distress and for specific targeted purposes. And we also recognize that sewer and solid waste and wastewater treatment facilities are presently being financed jointly by public-private partnerships, and those types of financing should continue.

Our three-part test? I will quickly outline that for you.

The first is that the facility must be publicly owned for tax purposes; no one takes the investment tax credit or depreciation on the facilities.

The second test is that the issuer ought to be functionally involved with the facility, that there ought to be some involvement from a regulatory, planning, or supervisory perspective.

The third test, and this is the test with the real bite, is that there ought to be some financial involvement on the part of the issuer, that the issuer cannot be simply serving as a conduit, that the bonds are issued on the basis of the jurisdiction's creditworthiness, and that the jurisdiction is financially involved by some significant portion.

One final comment. We are concerned about the loss of the deductibility of State and local taxes, for many reasons but also because of the impact it will have on the creditworthiness of our State and local borrowers. We are very concerned that marginal issuers will have their borrowing costs increased by changes in this deductibility provision.

We appreciate this opportunity to testify, Senators, and we would be happy to work with your staff on coming up with an alternative public-purpose definition.

The CHAIRMAN. Thank you.

Mr. Rousseau?

[Mr. John T. Walsh's written testimony follows:]

# STATEMENT

of

JOHN T. WALSH

on behalf of

GOVERNMENT FINANCE OFFICERS ASSOCIATION

regarding

TAX-EXEMPT BONDS

before the

COMMITTEE ON FINANCE
UNITED STATES SENATE

September 24, 1985
215 Dirksen Senate Office Building

Introduction

Good morning Mr. Chairman and members of the Committee. My name is John T. Walsh. I am President of the Government Finance Officers Association, as well as Finance Director for the City of Hartford, Connecticut.*

The debate over the exemption from federal income taxes of interest on bonds issued by state and local governments tends to regard state and local governments as special interest groups. First, we should recognize that state and local governments and the federal government all serve and must be supported by the same constituency.

A basic tenet of the federal system of government is the Constitutional doctrine of reciprocal immunity. The federal government cannot tax the interest on our bonds and we cannot tax the interest on federal government obligations. Notwithstanding the Constitutional basis of the exemption, it may be possible to restrict the issuance of obligations that are for the primary benefit of private users, and it is certainly not irresponsible to introduce this concept into the debate on the present tax reform proposals.

For more than 33 years our Association has held that there must be restrictions on the unlimited issuance of tax-exempt bonds that solely benefit private industry. As responsible finance officials we are aware of the potential future impacts of ever-increasing federal deficits. However, our primary concern is with the proliferation of these bonds in the municipal bond market and their effect on the interest rates paid for bonds issued to finance roads, schools, sewer and water systems and other government facilities.

*The Government Finance Officers Association is a professional association of 9,200 appointed and elected government officials who serve as treasurers, comptrollers, budget directors, retirement administrators, accountants, and auditors at the state and local level.

The Administration's Proposal on Tax-Exempt Bonds

We oppose the Administration's proposals on tax-exempt bonds. They are not reforms. They are an assault on all tax-exempt bonds, and as such have been opposed by every major national organization representing state and local issuers of tax-exempt bonds.

The Administration's plan not only affects the so-called "private-purpose" bonds, but also general obligation bonds and revenue bonds issued for governmental services and facilities including those that are now technically classified as industrial development bonds which finance such projects as

- o solid waste disposal,
- o sewer and water systems, and
- o airports, docks, and wharves.*

The Administration's plan substitutes restrictions that are more burdensome and complex than present law. Specifically, the GFOA and the other public official groups object to:

1. The proposed redefinition of governmental bonds which relies upon an arbitrary one-percent rule. This will affect bonds for indisputable governmental purposes.

2. The elimination of the deduction taken by banks and other financial institutions for the costs of buying and carry tax-exempt bonds. Many small jurisdictions that rely on local institutions for their capital financing will be hurt by this provision.

*These public facilities which are technically industrial development bonds are also adversely affected by congressional tax reform proposals.

3. The denial of tax-exempt financing if a government has a contract with a private firm to manage a public facility for more than one year. Frequently sewage treatment plants are managed this way.

4. The penalties the plan will impose on state and local officials who practice good cash and debt management. Arbitrage, when not abused, reduces the amount of bonds issued for a project and advanced refunding permits issuers to refinance their debt when interest rates decline.

5. The adoption of a new federal reporting requirement that will be costly and may be unconstitutional.

6. The disruption of the tax-exempt market as issuers rush to market in anticipation of a retroactive effective date for the bond provisions.

We believe the bank provisions could add more than a billion dollars annually to state and local borrowing costs. The proposed arbitrage changes will increase the amount borrowed for projects by 2 to 7 percent and the advanced refunding changes could mean millions in savings for the individual projects refinanced.

In a similar vein, proposals to include tax-exempt interest in the minimum individual tax base would affect our market adversely. A minimum tax proposal was offered in 1982 and defeated on the grounds that the federal government is barred by the Constitution from taxing state and local government securities.

## An Alternative Approach

Since there is a substantial chance that a tax bill may be adopted that could include provisions related to tax-exempt bonds, the Government

Finance Officers Association is recommending an alternative to the Administration's plan that would:

o preserve the tax-exempt status of governmental tax-supported general obligation and revenue bonds that are used to finance such projects as schools, roads, bridges and tunnels by establishing a new three-part test for public purpose described below;

o clarify that certain bonds that are currently classified as industrial development bonds, but pass the three-part test, should continue to be financed on a tax-exempt basis;

o support an exception to the three-part test that would allow tax-exempt financing for projects that primarily benefit private users that are targeted to areas of severe economic distress and to specific purposes such as housing; and

o recognize that solid waste disposal and wastewater treatment facilities are presently being financed jointly by public/private partnerships and these types of financings should be continued.

We propose that tax-exempt financing should be unchallenged if:

1. The facility being financed is publicly owned for tax purposes. Under this criterion, no private entity may use the investment tax credit or depreciate the property for federal income tax purposes if it is financed with tax-exempt bonds.

2. The issuer is functionally involved in the project. The functional involvement criterion can be satisfied if the issuer retains or exercises operational, supervisory, planning or regulatory control of the facility being financed. An example is where a government leases a portion of a facility to a private firm on a long-term basis, but retains

title to the property, has the right to approve sub-leases and changes in the use of the property, and may lease to another party either at the expiration of the lease or if the lessee vacates the premises.

3. The issuer is financially involved in the project. An issuer is financially involved in the project when it is reasonably expected that the debt is not to be secured solely by a single private entity. The financial involvement test is satisfied where a public entity has a meaningful financial commitment to make available revenues from its own sources or accepts a repayment obligation or a contingent commitment for a significant part (five percent) of the debt service.

In drafting and considering the above three criteria and the exceptions, it will be important to have a clear legislative history to prevent the broad, overly restrictive approach which Treasury is likely, based on history, to follow in the regulation process.

Impact of the Loss of Deductibility on Credit Quality

The denial of deductibility of state and local taxes is opposed by GFOA. Among other things, it will lead to a deterioration of the credit quality of tax-supported debt. Credit quality is important because the lower the quality the higher the interest rate and the more the government must pay to borrow. We believe this will harm many marginal communities which rely heavily on property taxes.

The Government Finance Officers Association appreciates this opportunity to testify and offers to work with you and your staff in designing an alternative to the Administration's plan. I respectfully request that my statement be entered into the record.

## STATEMENT BY JEAN J. ROUSSEAU, CHAIRMAN, PUBLIC SECURITIES ASSOCIATION, NEW YORK, NY

Mr. ROUSSEAU. Thank you, Mr. Chairman, Senators.

I am chairman of the Public Securities Association, and I am also senior vice president of Merrill Lynch Capital Markets, and I represent the Public Securities Association, the trade association for municipal securities dealers nationwide.

The administration's proposals concerning tax-exempt issuance in their tax reform proposal would very simply have the effect of eliminating 80 percent of the purposes and 80 percent of the volume of tax-exempt bonds issued by public entities for public purposes. We believe that this does not represent tax reform, and quite candidly believe that it should not be included in a tax reform deliberation.

The Treasury's proposals will not lower taxes, they will not create significant revenues for the Treasury at all, and they will not make the tax system fairer or more equitable. They will decrease city and States' ability to meet identified public needs. They will increase the costs and the risks of meeting those public needs and operating public facilities. And they will seriously impair if not destroy the privatization initiatives that have achieved so much cooperation between public and private bodies in recent years.

I think it is important to reflect just for a moment on the particulars of the administration's proposals.

The proposals would eliminate certain categorical public purposes such as all multifamily and single family housing bonds, all student loan bonds, all pollution control facility bonds, all not-for-profit health care and hospital bonds, and all not-for-profit university bonds, as well as convention and trade show facilities, and all small issue industrial revenue bonds.

Under the workings of their so-called 1-percent rule which would deny tax-exempt funding to any facility where there was any private involvement, they would also eliminate many if not all bonds issued for sewage and solid waste disposal, public power, air and water pollution control facilities, regional pollution control facilities, water supply, hydroelectric generating, airports, docks, mass commuting facilities, and all of the other convention and trade show facilities that they didn't get with the categorical eliminations.

In addition to that, they would deny municipalities and States the ability to advance refund their outstanding debt to achieve lower interest rates or more favorable bond covenants. And they would also, coincidentally, eliminate the ability of banks to deduct interest used for carrying municipal bonds.

It is an obvious tactic. It is a massive overkill proposal which would eliminate by several different means substantially more than half, indeed 80 percent, of the municipal market as it is presently constituted.

If I may, let me graphically illustrate that by drawing your attention to exhibit 1 in my testimony, which is a pie chart which shows the effect that the Treasury proposals, if they had been law, would have had on the municipal market in 1984. All of those purposes which I identified would be eliminated—everything in the dark area of this pie chart. And in addition to that, almost half of the bonds issued on a general obligation basis, or so-called—Treasury's definition—traditional revenue bonds would also have been eliminated either by the workings of the advance refunding proposal or by the workings of the 1-percent rule, or both.

So, of a $115 billion market, $92 billion would have been eliminated.

Treasury's rationale for this proposal is that it would eliminate abuse. Well, I think I need not go further than to say that something that eliminates 80 percent of a longstanding and legitimate public market is not a correction of abuse.

Furthermore, they say it would raise $13 to $16 billion in revenues which are needed. That simply is not going to turn out to be true. We commissioned Coopers & Lybrand, the national accounting firm, to study the Treasury's own methodology, and they concluded—and I would draw your attention to the bar chart—that, whereas Treasury indicates a gain of $13 billion, the Joint Committee on Taxation indicates gains of $16 billion, in fact the true gains to the Treasury would be less than $2 billion, using Treasury's own methodology, and no more than $3.5 billion using the Joint Tax Committee's estimates of revenue. And the cost to State and local governments in any case would be $41 billion over the same 4-year period of time.

We, as an industry organization, the municipal bond industry, obviously have a commercial interest in this matter. However, we also know the needs and the scarce resources and the limited options available to State and local issuers. I believe you have heard from many of them at home; I believe you will hear from many of them today. We urge you to consider their needs in your deliberations.

The CHAIRMAN. Thank you.

Mr. Feldman.

[Mr. Rousseau's written testimony follows:]

# STATEMENT OF

# JEAN J. ROUSSEAU, CHAIRMAN OF THE PUBLIC SECURITIES ASSOCIATION,

# BEFORE THE COMMITTEE ON FINANCE OF THE UNITED STATES SENATE

Washington, D.C.
September 24, 1985

STATEMENT OF JEAN J. ROUSSEAU, CHAIRMAN OF THE
PUBLIC SECURITIES ASSOCIATION, BEFORE THE
COMMITTEE ON FINANCE OF THE UNITED STATES SENATE

Washington, D.C.
September 24, 1985

## INTRODUCTION

Good afternoon. My name is Jean J. Rousseau. I am the elected Chairman of the Public Securities Association (PSA), the national organization of banks, dealers, and brokers that underwrite, trade and sell municipal securities, mortgage-backed securities, and U.S. Government and Federal Agency securities. PSA's 300 member firms collectively account for approximately 95 percent of the nation's municipal securities underwriting and trading activity. I am also a Senior Vice President and Director of the Municipal Securities Division of Merrill Lynch Capital Markets.

I wish to persuade you today to exclude from any consideration of "tax reform" the various provisions of the Administration's tax proposal regarding the issuance of tax exempt municipal bonds.

The elimination of what the Treasury Department has termed "private activity, non-governmental bonds" will not lower anyone's taxes. It will not make the tax system fairer or simpler. It will not contribute significant revenues to the U.S. Treasury.

This proposed elimination of tax exempt financing for an estimated 80 percent of the projects financed by state and local government officials last year will increase substantially the cost at which state and local governments finance capital improvements.

It will significantly decrease their ability to control and reduce operating risks and costs through working partnerships with private sector enterprise. It will encourage creation of new government bureaucracies, replacing the very promising privatization initiatives of recent years. It will also undermine the historic partnership between state and local governments and community-based non-profit, charitable institutions across the United States.

This is not "tax reform". It is tax shifting, from the Federal to the state and local level. And it is a serious, if unintended, blow at the New Federalism which this Administration has championed.

## THE SPECIFICS OF THE PROPOSAL

First, I want to make sure you are aware of how thoroughly sweeping and radical these proposals are. The Treasury has proposed to hurl four thunderbolts at the municipal market, any one of which would be sufficient to cripple the ability of state and local governments to fund vitally needed public facilities on a cost effective basis. Those thunderbolts, and their independent crippling effects on the market, are:

i) elimination of certain exempt purposes which represents a 71% reduction in 1984 volume;

ii) The "1% Rule" -- if one percent or more of the proceeds of a bond issue directly or indirectly benefit a non-governmental entity the bonds would be issued on a taxable basis -- which would reduce volume in 1984 by 52%;

iii) drastic alteration in "arbitrage" rules (funding during construction) which represents approximately a 40% reduction in 1984 volume; and

iv) elimination of advanced refundings representing a 2% reduction in 1984 volume (this percentage would be substantially higher in periods of declining interest rates).

The tactic is obvious - a massive overkill proposal leaving plenty of room for apparent "compromise" but still more than enough damage to the structure of the market to achieve Treasury's goal of the effective elimination of this time honored public benefit facility. The tactic is as outrageous as it is obvious, and yet it has not been supported either by valid citations of "abuses" to be eliminated or by estimates of revenues to gained. The Treasury's proposal cannot be taken seriously as a starting point for discussion of the municipal market. It must be laid aside entirely and the market considered on its own true and considerable merits.

The practical application of these Treasury recommendations will eliminate the tax exemption for all multi-family and single family housing bonds, student loan bonds, pollution control bonds, not-for-profit hospital and private university bonds; many, if not most, bonds issued for sewage and solid waste disposal, public power, air and water pollution control facilities; water supply facilities; hydroelectric generating facilities; airports, docks, mass commuting facilities; convention and trade show facilities, and small issue industrial development bonds; and some additional general obligation and "traditional" revenue bonds for other types of projects.

For example, sixty percent of the nation's hospitals are organized as not-for-profit institutions. Under these proposals, construction and rehabilitation of such hospital facilities would not qualify for tax-exempt financing. The result: higher costs for hospital improvements and higher hospital fees.

Other provisions affecting municipal finance include the elimination of advanced refundings of any outstanding tax exempt bonds, regardless of purpose; the elimination of the deductibility of carrying costs for bank purchases of municipal bonds; and severe restrictions on the reinvestment of proceeds by state and local governments ("arbitrage").

The elimination of advanced refunding would deny state and local governments the ability to lower the cost of borrowing during a period of declining interest rates and to remove provisions in original bond covenants which restrict future actions by the issuer.

Advanced refunding is an accepted, prudent practice in the market for state and local securities. Many state and local government securities are issued with "call" provisions which allow issuers to repurchase their bonds. In many instances "call" provisions are limited to specific periods of time well into the life of the bond, i.e. bonds may be called annually only after the tenth year. As a result, in order to take advantage of lower interest rates, a state or local government will issue refunding bonds if it cannot "call" the outstanding bonds.

Limited "call" provisions and the ability to issue advanced refunding bonds work two ways to lower borrowing costs for states and localities. By utilizing advanced refundings, state and local governments can combine the advantages of the lower interest costs associated with issuing securities with longer call periods which protect investors against declining interest rates, and also take advantage of refinancing opportunities to lower interest costs if rates decline sharply. Thu3, advanced refunding bonds provide state and local governments with a means of lowering their cost of borrowing without increasing risk.

The imposition of new requirements on arbitrage would severely restrict issuers during construction of major projects. These restrictions generally limit the instances where proceeds raised at tax-exempt rates can be invested in securities which pay interest at higher taxable rates and they also significantly limit the time periods in which investment proceeds can be reinvested with limited restrictions.

The proposal would require generally that investment earnings from the proceeds of a tax-exempt bond issue which are not invested to directly carry out the purposes of the bond issue be rebated to the federal government. Other requirements in the proposal make more severe the rules regarding reinvestment of allowable reserves.

The proposal also would significantly diminish the period of time immediately after the bonds have been issued during which liberal reinvestment standards are in place. This time period is termed the temporary period. The proposal would limit applicability of the temporary period standard to construction projects where a "significant amount" of the bond proceeds are expended within one month (currently six months is allowed) of issuance. This proposed restriction does not reflect accurately the timing of expenditures during construction of major facilities and therefore seems to be quite arbitrary. This provision may also force issuers to finance construction of new projects through means, such as bank loans with periodic draw down provisions, that would significantly raise the cost of financing new projects.

I would draw your attention to Exhibit 1, attached to my statement. Using the Treasury Department's data on tax-exempt issuances during 1984 and our own estimate of the additional general obligation and so-called "traditional" revenue bonds affected by the one percent rule, the pie chart indicates the volume and types of financings which would be affected.

Let me be clear what "affected" means. If these provisions are enacted by Congress, the indicated financings would either:

1. Be financed with taxable bonds, at 30-35 percent higher interest rates and 50 to 100 percent higher total capital cost; or
2. Be radically restructured to eliminate private, non-governmental involvement; or
3. Not be constructed at all.

These hard choices will confront issuers for approximately 80 percent of the tax-exempt new-issue market. We know, for instance, that 80 percent of all revenue bonds issued last year would have lost tax-exempt status.

In short, this is not a minor change. It does not apply merely to "IDBs," of which "small issues" already face legislative sunsets in 1986 and 1988. It does not protect general obligation or "traditional" revenue bonds. It does not protect "public purpose" facilities as the public would understand that term.

## RESULTING REVENUE GAINS ARE INSIGNIFICANT

The presumed rationale for such sweeping change is to "close a tax loop hole" and thereby raise additional revenues for Treasury. Treasury estimates that its recommendations will produce a $13 billion gain for the period 1986 to 1990. Using the Treasury's methodology the Joint Committee on Taxation ("JTC") estimates a $16 million revenue gain for the same period (the JTC estimate differs from Treasury's because of different interest rate projections). We believe the Treasury and the JTC estimates are seriously overstated.

The Public Securities Association commissioned the national accounting firm of Coopers & Lybrand ("C&L") to conduct a study of the impact on Federal revenues of the proposed elimination of tax-exempt securities as recommended by Treasury. The results of the Coopers & Lybrand study indicate that the Treasury methodology is seriously flawed.

It is important to note that C&L's own estimates are not the result of an entirely different econometric model. C&L's estimates were generated by replicating the Treasury methodology and correcting its major shortcomings; namely, the biasing assumptions that

- All projects denied tax exempt status would be financed with fully-taxable bonds;
- All affected investment in tax-exempt bonds would shift entirely to taxable investments (ignoring the continued availability of other tax-favored investments);
- No construction dollars, jobs or other economic activity ("reflows")--and the tax income flowing therefrom--generated by projects currently financed by tax exempt bonds.

Having corrected these short-comings, C&L estimates that anticipated revenues to the Federal government will be, at a maximum, $3.5 billion for the five year period--about one-fifth of the JTC forecast.

In addition, there are other factors that would reduce Treasury's and JTC's revenue gain estimates that were not considered in the C&L study. A major factor is the effect of eliminating advanced refundings on a relatively inexpense source of financing for the Treasury, namely, State & Local Government Series or "SLGS". When an issuer conducts an advanced refunding the proceeds are invested in SLGS. The interest rate on SLGS is the same as that of the advanced refunding. SLGS therefore provide the Treasury with financing at a tax-exempt rate thereby providing a revenue gain to the Treasury. Elimination of advanced refunding would in effect, provide a revenue loss to the Treasury. Preliminary estimates by C&L indicate that this revenue loss would amount to $2.25-3.0 billion from 1986 to 1990.

## THE HIGH COSTS IMPOSED ON STATE AND LOCAL GOVERNMENT

While the Coopers & Lybrand study shows that eliminating of so-called "private activity" bonds would not produce material additional revenues--if any--to the Federal government, the increased costs in state and local taxes and user fees are potentially enormous.

If all the projects affected by these provisions were to be financed in the taxable market at an average increased interest rate of 3 percent, the increased five-year cost would be $41 billion. I draw your attention to Exhibit 2, attached, to compare Treasury's revenue gain with the increased costs to state and local governments and taxpayers.

## CONCLUSIONS

The municipal securities industry, as represented by PSA, believes that any proposal which so dramatically impacts state and local government finance and threatens huge new costs in state and local taxes and user fees in relation to minimal increased revenues to the Federal government should be removed from your otherwise worthy efforts--and those of this Administration--to reform, simplify and make more equitable the Federal income tax system.

As I have said before, this is not tax reform. Rather, it is an unfortunate outgrowth of a long-held and fundamentally hostile attitude by the Treasury Department which would prefer the elimination of all tax exempt finance by state and local governments, as has now been recognized in public pronouncements of senior Treasury officials.

As representatives of the industry, the members of PSA clearly have a commercial interest in the volume of tax exempt bonds issued. However, we also have an experienced perspective on the needs and desires, but also on the limited range of financing options available to state and local officials who--whether elected or appointed--are responsible to their constituents (and yours) for providing capital-intensive services on the most cost-effective basis.

We urge you to listen to them both in these hearings and at home in your districts. In particular, we urge you to consider those projects in your home districts--the planned airport expansions, community hospital modernizations, low and moderate income housing projects, solid waste treatment plants, and so on--which will be adversely affected by these proposals.

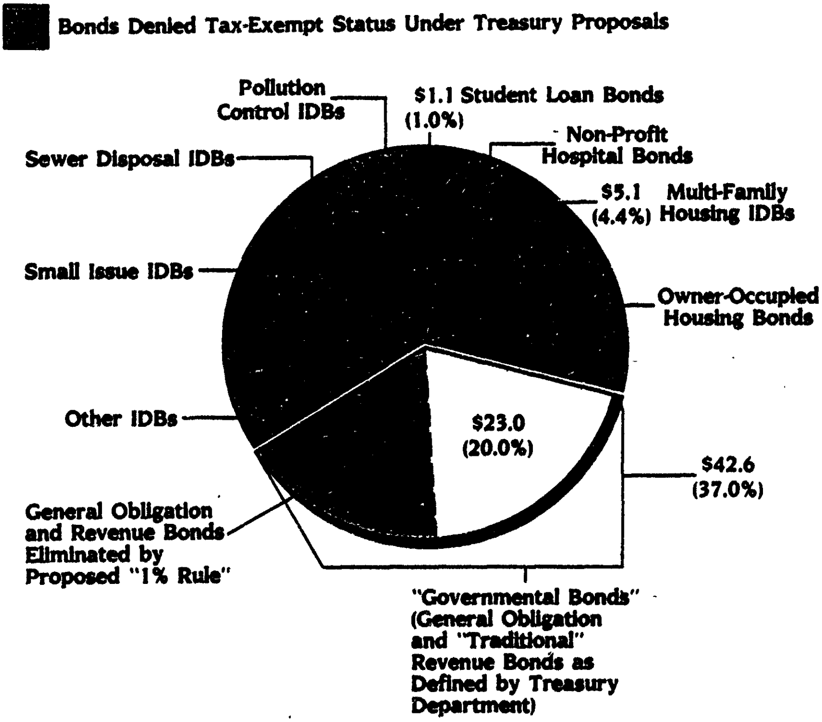
Thank you very much for your attention.

Attachments

EXHIBIT 1

## 1984 Long-Term Municipal Bond Issuance Showing Effects of Changes Proposed by Treasury Department

($ in Billions)



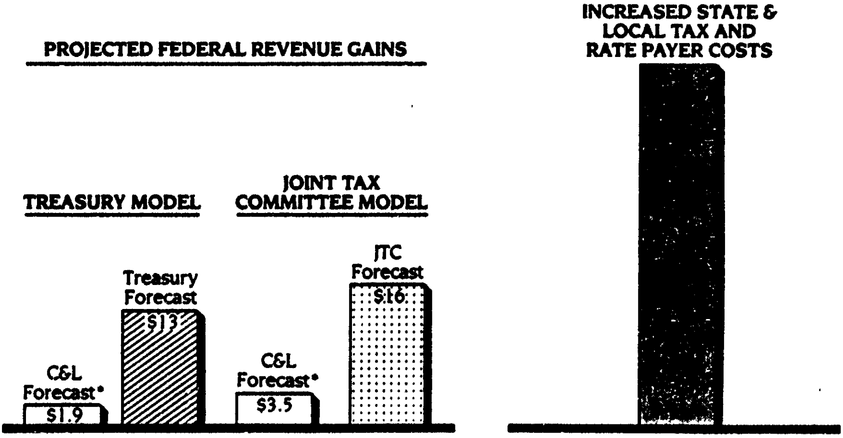
**Total Issued: $115.1**
**Total Denied Tax-Exempt Status: $92.1**

Source for All Volume Figures Is U.S. Treasury Department Except Portion of G.O. and Rev. Bonds Affected by "1% Rule" for Which the Source Is Public Securities Association Estimate.

EXHIBIT 2

# Added Costs to Taxpayers and Ratepayers From Treasury Proposals to Restrict Tax-Exempt Issuance Are Three Times More Than Treasury Gain Forecasts

($ in Billions)



Cumulative Federal Revenue Gain Through 1990

Added Costs to State and Local Issuers Through 1990 From Elimination of Tax-Exempt Issuance Under Treasury Department Proposal**

*"An Analysis of Treasury Estimates of Revenue Gains From the Proposed Elimination of Selected Tax-Exempt Securities" — Coopers & Lybrand, July 15, 1985; Updated August 1985.

**Source: Public Securities Association.

EXHIBIT III

# Rationale

The $41 Billion Amount Was Calculated by Determining the 1984 Volume of *Known* Tax-Exempt Bond Issues Which Would Have Had to Be Issued on a Taxable Basis if the Treasury Department Proposals Had Been in Effect.

This Volume ($92 Billion) Was Then Projected to Be Issued as Taxable Bonds From 1986 Through 1990. 10% Tax-Exempt Interest Rates and 13% Taxable Interest Rates Were Assumed.

Source: Public Securities Association

## STATEMENT BY ROGER D. FELDMAN, VICE CHAIRMAN, PRIVATIZATION COUNCIL, INC., WASHINGTON, DC

Mr. FELDMAN. Thank you, Mr. Chairman, Senators.

My name is Roger Feldman. I am the vice chairman of the Privatization Council, Inc., which is a nonprofit corporation focused on the analysis of cost-effective roles which the private sector can play in performing traditionally public activities, so-called privatization.

As you all know, privatization has been implemented in many areas—water treatment, municipal solid waste/resource recovery, transportation, correctional systems.

The reason for the attention to privatization is because of the growing so-called infrastructure gap between public resources and public needs, which the Joint Economic Committee recently estimated at $1 billion. EPA estimated water treatment requirements in the area of $100 million by 1990.

Privatization does two things: It attracts private capital and it results in net capital and operating savings to the public bodies.

We have done a study—various other studies have been done—and reflected that public bodies realize between 15 and 25 percent capital savings from privatization projects.

Additionally, some of these projects entail risk that is absorbed by the private sector, and there are operating efficiencies, including in some cases revenues.

The important fact to focus on is that these benefits are captured in the form of service fees to public consumers. Now, as you know, the 1984 Tax Act specifically focused on imposing risks on those private persons who claim tax benefits when providing services to public bodies. The effect of Treasury II clearly is to do away with the possibility of privatization in any significant measure, by terminating the ITC, elongating the ACRS, and effectively precluding the use of tax-exempt industrial development bonds. There is no incentive to the public, there is no reward to the private side.

And we don't feel that there really is anything in the record to justify the alleged revenue savings from this action. Specifically, there has been no attention either to the positive tax benefits when you get private parties into the operation of facilities, nor to the multiplier effect that follows upon that. Nor has there been attention to the fact that, absent privatization, either municipal and local governments will have to go to additional tax-exempt GO's if that is feasible, or they are simply going to directly or indirectly have to tax the consumers of the public services; the very people supposed to be benefited by the Tax Reform Act are the ones who are going to be harmed.

Now, we believe that in order to realize the net positive benefits of privatization, two things are necessary: One is simply to have a stability in knowing what the rules are in accordance with which you can privatize; the second that follows from that is simply to, in effect, create a safe harbor for a very carefully defined class—public purpose projects, which are public-private joint ventures, which are clearly related to infrastructure. For those projects alone we suggest that the current tax treatment of ACRS and ITC be preserved.

Similarly, the proposed 1-percent rule restricting the use of IRB and other tax-exempt debt should not be made applicable only to that defined class of public-purpose facilities which are known as infrastructure.

It really is not our intent to try to create some kind of special-interest legislation. Privatization has been demonstrated to be a successful means—and the administration has endorsed it—of getting the private sector involved in providing essential public services. We think that the congressional preservation of the possibility of necessary and sound public-private partnerships will make the whole package more attractive to State and local governments, particularly in the infrastructure area.

In concluding, we strongly urge that in structuring tax reform, recognition be given the public interest in preserving those selected benefits of privatization.

Thank you very much.

The CHAIRMAN. Thank you, sir.

[Mr. Feldman's written testimony follows:]

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# TESTIMONY OF THE PRIVATIZATION COUNCIL, INC.

Presented by Roger D. Feldman,
Vice Chairman

Partner, Nixon, Hargrave, Devans & Doyle
Washington, D.C.

SENATE FINANCE COMMITTEE
September 24, 1985

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## Privatization: An Important Financial and Management Tool for Government

The Privatization Council, Inc. is a non-profit corporation organized to inform the public and private sectors as to the productive roles that public-private partnerships can play in the finance and operation of traditionally public services. Examples of successfully privatized projects abound, including the development, acquisition and expansion of water and wastewater systems, solid waste/resource recovery projects, transportation systems, correctional facilities, parking garages, and the range of other public works that has come to be known as "infrastructure".

Privatization has been found to be in the public interest when structured properly. In 1984, the Congress provided clear guidelines as to future privatization transactions. The Tax Reform Act of 1984[1] contemplates that

[1] Section 7701(e), Internal Revenue Code

a private sector developer of a project performing public functions may be eligible for tax benefits under other provisions of the Code, notably the investment tax credit and rapid depreciation, so long as the operational and financial risks fall on his shoulders. Under these circumstances, a private sector developer may finance, construct, own and operate the facility and charge the community involved a service fee for the public services in question. Facilities for performance of certain of these services, such as solid waste disposal, also are eligible for tax-exempt financing.

Privatization is attractive to state and local governments for a number of reasons. First, in many cases, there are simply no longer sufficient funds available to governments to meet the complete range of society's needs which traditionally have been provided through the public sector. It has been well documented that the amount needed to build or repair our nation's infrastructure ranges into the trillions of dollars. The EPA estimates that over $100 billion of new construction is needed to satisfy the requirements of the Clean Water Act alone. Larger sums will be needed to meet drinking water and solid waste needs. Private sector involvement allows government entities to allocate scarce public dollars to more projects. Second, such projects allow the government entity to shift technological, completion, and operational risks to the private entity. Third, the non-governmental entity is usually able to provide the public service at a significantly lower cost to the taxpayers.

State and local governments realize such economic benefits because the service fees charged by the private entity are lower than the government entity's cost of providing the service. That difference is due to efficiency and productivity gains and lowered costs arising from private operation, as well as the realization of the tax benefits mentioned earlier which are now clearly available to the private sector. Efficiency gains are the result of innovative management techniques, new technologies and the introduction of a profit motive.

The key to realization of these gains is the injection of private risk capital into public purpose projects. Because of the important role played by tax benefits in attracting such risk capital to infrastructure projects, the Privatization Council has focused its attention and research on the potential impact of proposed tax reform. Specifically, its attention has focused on research concerning the probable effects of Treasury II on (i) privatization; (ii) infrastructure development; and (iii) Treasury revenues.

## Analysis of Impacts of Treasury II

### (1) Privatization

The Administration's proposed tax reform act in large measure reduces tax incentives for privatization. As discussed below, it would effectively terminate industrial development bonds and the investment tax credit and would more than double the period over which assets may be depreciated. It is a complex task to quantify the economic ramifications of stultifying privatization in the manner proposed. We have made reference to three key studies, as supplemented by the observations of other analysts.

The Privatization Council commissioned a study by Touche Ross & Co. entitled "Impacts of Tax Proposals on Privatization Transactions" that discusses the overall consequences of the proposed tax bill on an actual wastewater treatment plant privatization project. The study concludes that, from the local government perspective, under the current tax law the privatization/service contract alternative is the least expensive way of providing the service in question, resulting in actual savings of nearly 14% of the estimated lifetime project costs when compared to a conventional revenue bond financing. Should the tax proposal become law, the savings would be significantly lower, being derived substantially from the economies arising from savings associated with cheaper operating and maintenance costs, as there would be very little capital construction cost savings.

Metcalf & Eddy, one of the Council's sponsors, focused its analysis only on the capital portion of a representative wastewater project. It concluded that privatization under the service contract approach saved between 15-25% over conventional public financing. Treasury II would reduce capital cost savings to 5-10%. It questions the adequacy of such savings to provide a municipal incentive for privatization. A preliminary study by Arthur Young furnished to the Council indicates that, even utilizing conservative assumptions, not only are cost savings from privatization foregone, but in the case where no tax-exempt debt is available, privatized projects are actually rendered more expensive than traditionally financed public facilities.

The clear economic losses to the public only partially reveal the harm done. By reducing the potential for private sector involvement, the proposed tax bill will foreclose the opportunity for state and local governments to make use of private sector efficiencies, innovative management techniques and new technologies. Also lost would be the ability to build in flexibility in user fees and in the terms and conditions of service contracts to accommodate unique local conditions, such as projected growth.

(2) Senate Infrastructure Advisory Panel Study

Is the cost of "tax reform" to State and local governments offset by other larger scale public benefits? The answer appears to be clearly in the negative. The Private Sector Advisory Panel on Infrastructure Financing study entitled "The Implications of Tax Reform for Infrastructure Financing and Capital Formation" was submitted to the U.S. Senate Committee on the Budget. This study, commissioned by the Committee on the Budget Advisory to the U.S. Senate, concluded that the loss of tax-exempt financing would have undesirable effects on the infrastructure of the country at a time when the replacement and construction of the infrastructure is badly needed.

The Study pointed out that a wide range of independent experts had estimated hundreds of billions of dollars shortfall in public infrastructure funds by the year 2000, including the Joint Economic Committee (estimated $1.1 trillion requirement) and the Congressional Budget Office (estimated $860 billion). It highlights how, as a practical matter, the proposed Treasury II requires that (i) no more than 1% of bond proceeds may be used by a non-governmental person; (ii) for any bond to be exempt, the facilities must be available for actual use by the general public on the same basis as a private user; and (iii) tax-exempt financed facilities may be used by a non-governmental entity only under a short term management contract effectively prohibiting many of the privatizatized infrastructure-type activities currently financed by general obligation and revenue bonds under Sections 103(a) or 103(b). The resulting shortfall of public-purpose projects will significantly impair the prospects of satisfying the ever-increasing infrastructure requirements of the country.

(3) Revenue Neutrality

It is sometimes argued that even though state and local governments will find it more expensive to provide public services, the increased expense is justified by the reduction of revenue losses that the U.S. Treasury may experience. It is our opinion that privatization transactions will in most cases contribute more to the Treasury than is initially "lost" through the various tax provisions. Privatized projects are constructed, owned, and operated by private, for-profit entities that pay income, sales, and property taxes which otherwise would not be realized if ownership remains with the public sector. Preliminary analyses by Metcalf & Eddy suggest that taking into account taxes paid by all of the contributors to a privatized project, some projects may actually produce a positive effect on Treasury revenues because the taxes paid by the contributors exceed the tax benefits over the life of the project.

Moreover, the revenue calculated by the Treasury and the Joint Economic Committee to be gained by eliminating tax-exempt bonds seems to be far less than expected. In a study commissioned by the Public Securities Association, Coopers & Lybrand analyzed the proposed elimination of tax-exempt securities. The study concluded that the method by which the U.S. Treasury and the Joint Committee on Taxation (JCT) estimated the revenue gains to be realized by eliminating tax-exempt bonds was seriously flawed. Rather than a revenue gain of $13 to $16 billion during the years 1986 through 1990, Coopers & Lybrand estimated the revenue gain to be $0.43 billion to $1.98 billion over the same period.

The study concludes that the methodology used by the U.S. Treasury and JCT is incomplete in that it ignores the multiplier effect and other indirect economic effects of the loss of tax-exempt financing. One of the primary purposes of issuing state and local tax-exempt bonds is to generate ancillary economic benefits as well as to serve the stated public purpose. In addition, the methodology fails to account for the cost of long-term infrastructure deterioration due to the loss of certain tax-exempt projects.

In part by ignoring the potential of privatization as unquantifiable, the JCT report reached conclusions which may be subject to serious question. The Coopers & Lybrand study also challenges assumptions used by the JCT and Treasury, notably that: (i) the entire volume of tax-exempt bonds would be issued as taxable bonds, (ii) the allocation of debt and equity in the capital markets would remain unchanged, and (iii) there is no market recognition of the varying risks and characteristics of tax-exempt bonds. These highly questionable assumptions contribute to an overestimation of the Treasury revenue gains to be derived from the elimination of tax-exempt bonds.

The study suggests that a more realistic set of assumptions leads to the conclusion that the increased revenue rationale for elimination of tax-exempt IDBs, is not as likely or as dramatic as is estimated by the U.S. Treasury or the JCT.

Conclusions

In the past several years, the privatization of public services has emerged as a trend hailed by a broad political spectrum as serving the public interest. The privatization of water treatment plants, solid waste/resource recovery facilities, and correctional facilities has been widely reported in the media. The greatest obstacle to privatization has not been lack of recognizing its benefits but rather the lack of reliable and consistent tax treatment of the private sector. In the Tax Reform Act of 1984 Congress set forth the conditions under which tax benefits would be available for privatized projects. But the current Treasury II proposal is causing confusion and skewing the emerging privatization marketplace. A great number of projects are rushing to closing, motivated by concern with the statutory effective dates of the several provisions alluded to above. The public purposes and benefits of the 1984 Act are already being harmed, even though legislation has not passed.

The studies discussed above all point to some fundamental conclusions, which we urge the Congress to recognize in formulating any tax reform package:

- The involvement of private capital and initiative in previously public activities, motivated by the availability of certain tax benefits, represents an efficient use of the tax system to meet genuine public needs which otherwise would not be met, i.e., infrastructure capital, technological risk absorption, innovation, and better management.

- Treasury II would greatly impair all privatization and would destroy privatization using tax-exempt bonds. This has been quantified and its effect will be apparent in a reduced level of public services.

- Treasury II will impose substantial hidden taxes by raising the taxes and fees that state and local governments must charge to pay for public services that would otherwise be privatized.

- The benefits to the Treasury from eliminating privatization using tax-exempt bonds are dubious if realistic economic assumptions are used.

- It is desirable to define a class of public purpose, public-private joint ventures whose benefits from privatization outweigh the alleged revenue impacts on the Treasury. These projects should remain eligible for the ITC, accelerated depreciation and tax-exempt IDBs in a manner which does the least harm to the fabric of the reformed tax laws otherwise applicable.

The result of adopting these recommendations will not benefit a narrow, private sector special interest group, but rather produce a broad, quantifiable benefit to the public as a consumer of services from entities at all levels.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

Ms. Spain, you set forth three criteria that you felt should be met.

Mr. Feldman, I assume you wouldn't agree with those three criteria. For instance, one of the criteria was that the ITC not be used.

Mr. FELDMAN. I would have to say that, as to the first criterion, I don't agree. But I think that the second and third criteria could be worked with in structuring an appropriate treatment of infrastructure financing.

Senator CHAFEE. Now, it seems to me that one reason we are into this business as part of the tax reform, regardless of whether the Treasury had come up with it, is because this committee has long been disturbed over the use of IDB's and how they have been used.

I read Mr. Rousseau's statement, and on page 6 he sees no trouble with arbitrage proceeds. For example, as I understand it, it is quite all right for a local government or State government to go out and issue bonds, get the receipts, invest them in high-yielding private securities, and make a good profit that way. Is that correct?

Mr. ROUSSEAU. No, Senator; I would submit that the very extensive legislation presently on the books adequately ensures that no such thing can be done. The Treasury's further proposals concerning arbitrage would drastically limit the ability of issuers to enjoy reinvestment during the normal construction period of a facility. And I am by no means proposing rolling back the very extensive legislation and regulation on the subject already on the books.

Senator CHAFEE. What do you think about some requirements that before any of these bonds can be issued there should be competitive bidding between bond counselors as to who is going to come forward with the lowest fees, and the issuers have some competitive bidding there? In other words, certainly in my State—I can't speak for other States—there has been some controversy over this matter. A few people have gotten all the work. A few attorneys or a few houses have issued the bonds. I personally feel we ought to put in the law, at least, whether we do anything with the tax reform or not, some competitive bidding on those factors. What do you think of that?

Mr. ROUSSEAU. Let me say, Senator, that in your very own State of Rhode Island the present administration has determined that one group should not receive the benefit of all of the State's business, and in fact they have made very extensive changes.

Senator CHAFEE. Yes; they only did that after a scandal erupted, in which it came to the public's attention. But before that things were cruising along rather nicely—at least, rather nicely for certain lawyers and certain firms.

Mr. ROUSSEAU. I think that a requirement that issues be submitted to public bidding would not benefit State and local governments. Indeed, 20 years ago, 90 percent of issues were sold on a competitive-bidding basis. Nowadays, 70 percent are sold on a negotiated basis. That is a change that State and local governments themselves have effected in order to deal with the complexities of dead issuance and the uncertainties of the marketplace.

Senator CHAFEE. Well, I am not suggesting that it ought to be an advertised public bid where everybody comes in; but there is a difference, it seems to me, between a negotiated bid and just going directly to one house. A negotiated bid assumes you talk with several houses and come up with what is the best deal for the State or the municipality.

Mr. ROUSSEAU. Let me assure you, Senator, that ours is a highly competitive business. There are more than 100 firms who are active in the negotiation of issues, and we compete downright viciously with each other. And public officials take very sound and appropriate advantage of that competitiveness.

Senator CHAFEE. How about lawyers?

Mr. ROUSSEAU. Well, I believe the same is true. The number of bond lawyers in the United States has increased dramatically in recent years; whereas, there were formerly only about 30 firms in the country.

Senator CHAFEE. You know, it used to be a very cozy little business; you had to be in the green book, was it?

Mr. ROUSSEAU. The red book.

Senator CHAFEE. The red book. Everybody that got in kept everybody else out. It all worked very nicely, to the advantage of everybody but maybe the public. But now you say that is not true.

Mr. ROUSSEAU. There are hundreds of firms who provide legal opinions, legal counsel, with respect to State and local dead issuance, a vast increase in recent years. And there are many, many firms active in both the competitive and negotiated financing area.

Senator CHAFEE. OK. My time is nearly up.

Can I ask one quick question of Ms. Spain?

The CHAIRMAN. Go ahead.

Senator CHAFEE. Ms. Spain, you say in your statement that you do not want to countenance any arbitrage when not abused. When is it abused?

Ms. SPAIN. Senator, last year in connection with the 1984 tax bill, we worked with the Senate Finance staff, the Ways and Means staff, and the Joint Tax staff to try to determine if there were any abuses. And if there were, we said: "Let's work on them, and let's come up with an alternative proposal," which we did.

Senator CHAFEE. Can you detail me an abuse?

Ms. SPAIN. Some of the examples that were given to us, anecdotal, were early issuance, high financing costs. Basically those were the types of problems that were pointed out to us. But when we came up with an alternative proposal and suggested ways to deal with them, it was learned by us that we felt it was really a grab at revenues from State and local government, and so our proposal was not given any consideration.

Senator CHAFEE. Fine. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Grassley.

Senator GRASSLEY. Mr. Chairman, I have no questions of this panel.

The CHAIRMAN. Mr. Feldman, what is a public purpose?

Mr. FELDMAN. I would say activities such as the handling of municipal waste, the——

The CHAIRMAN. Now, let me rephrase it: What is not a public purpose?

Mr. FELDMAN. I think the line between public and private purposes is one that has emerged historically. At one time, to give you a farfetched example, the provision of police services was a private function. Obviously, it became a public function. At one time the handling of municipal waste was a private function; it became a public function.

In terms of focusing on this issue today, what I would recommend is to look at the activities that over the past 20 years have traditionally been performed by public bodies and have begun to be performed by private bodies, and make a judgment, a very hard judgment, of whether in fact we want to encourage the involvement of private capital and initiative in those particular activities.

The CHAIRMAN. I want you to separate the two. I think it is very good to privatize what are public services. That doesn't bother me a bit.

But I am more curious about what is a public purpose even if the Government does it. Is anything the Government does a public purpose?

Mr. FELDMAN. Well, I mean certainly the protection of the health and welfare of a municipality or a jurisdiction.

The CHAIRMAN. OK. Let me give you some specifics, sir.

Mr. FELDMAN. Sure.

The CHAIRMAN. Housing.

Mr. FELDMAN. From time to time the Congress of course has treated housing as a public purpose. My purpose here is not to suggest that privatization should extend into the housing area.

The CHAIRMAN. Should there be any limit on housing bonds that States wish to issue? And I am not going to argue about $500,000 homes; there aren't any like that. But for modest housing.

Mr. FELDMAN. I think the issue that has to be focused on is whether bringing private capital to the particular marketplace would occur absent providing these special privatization-type benefits.

The CHAIRMAN. In your judgment, what do you think about housing?

Mr. FELDMAN. I would first confess that I am not a housing specialist, and in my personal judgment I would think that when you get to the very low-income part of the scale the Congress has tried various other approaches to involving private capital in low-income housing, and I think it is possible that some measures might be appropriate. But I don't want to hold myself out as an expert on that subject.

The CHAIRMAN. What about job creation? Is that a legitimate public purpose?

Mr. FELDMAN. I will give you a two-part answer to that. I think it is a legitimate public purpose and was found to be such as long ago as the Full Employment Act; but I don't think it is the kind of public purpose that I am referring to as a privatization-type public purpose in the context of this particular tax law.

The CHAIRMAN. Well, let me ask you very specifically: should we have any limit? We have a small bond limit now, but should there be any limit on the desire of local governments, State or otherwise, to attract business by offering them through industrial development bonds with very attractive terms?

Mr. FELDMAN. OK. Now I understand the thrust of your question.

I believe that I am not a Trojan Horse for the small issue exemption. I believe that the issue of privatization for particular public purposes has to be addressed specifically, and I would not try to justify the small issue exemption on a job-creation theory or a housing theory, or anything else. That is not my intent in being here today.

The CHAIRMAN. Ms. Spain, I take it that your definition of public purpose is your three-part definition, and if they fit into that, that is a public purpose.

Ms. SPAIN. Yes, Senator.

The CHAIRMAN. Mr. Rousseau.

Mr. ROUSSEAU. Mr. Chairman, I believe that public purpose is best determined and defined by public officials, and I believe that State and local government officials do just that—make different determinations in different places according to their individual needs.

Undeniably, the Congress has injected itself into that determination from time to time, beginning in 1969, so, the State and local determinations, modified by what Congress has on the books in section 103, I would say is the appropriate definition of public purpose.

The CHAIRMAN. But from your standpoint, you think that ought to be up to State and local officials. And if they want to undertake something, that is a public purpose?

Mr. ROUSSEAU. Yes, sir.

The CHAIRMAN. A rose is a rose is a rose, if they call it a rose?

Mr. ROUSSEAU. Yes, sir.

The CHAIRMAN. I don't think I have any more questions. I appreciate it very much. Ms. Spain, you did very well.

Ms. SPAIN. Thank you, Senator.

Mr. ROUSSEAU. Thank you, sir.

The CHAIRMAN. Now let us move on to a panel of Bill Rutherford, the State treasurer from Oregon; the Honorable Grady Patterson, the State treasurer from South Carolina, James Solem, the executive director of the Minnesota Finance Agency; and Jessie Tilton, general manager, Indiana Municipal Power Agency, Indianapolis, IN.

I might take just a moment to introduce my old friend Bill Rutherford, who is a longstanding personal and political friend, who is Oregon's elected political treasurer and has done an extraordinary job in the time he has held the office, and prior to that in the State legislature. He has been before this committee a number of times. It is good to have you back again, Bill.

Mr. RUTHERFORD. Thank you very much, Senator, for that kind comment. I am only sorry that the cameras weren't running. [Laughter.]

Senator MITCHELL. Mr. Chairman, might I note also the presence with the panel of Kathleen Boland, the executive director of the Maine State Housing Authority. She is very effective and highly respected in this field and has done a great job in the State of Maine. We are pleased to have her here today.

The CHAIRMAN. Good to have you with us.

Go right ahead, Bill.

## STATEMENT BY HON. BILL RUTHERFORD, STATE TREASURER, STATE OF OREGON, SALEM, OR

Mr. RUTHERFORD. Thank you, Senator, very much for the opportunity and the privilege to appear before you today. I do think it is a privilege and remarkable that an individual citizen can still appear before the most powerful legislative assembly in the world and be heard.

I thought in preparation for my comments today that I would elaborate upon the written statement which I have given to you and discuss with you some of the matters with respect to tax-exempt bonds not only as they affect Oregon but broader public policy as well.

I could tell you about Oregon, where 80 percent of the tax-exempt bonds would be eliminated under this measure, bonds such as veterans housing, housing for disabled and elderly, pollution control, higher education, and potentially even schools, and possibly even a new convention center in Portland or expansion of our port and airport facilities in Portland, one of the few bright spots in the Oregon economy.

But I didn't want to limit my discussion just to that, to just Oregon, where in the period of 1986 to 1990, Oregonians would be asked to pay an additional $413 million in additional interest if this measure were to pass. That is nearly $200 for every man, woman, and child in the State. But I thought I would speak to you about a broader subject today, which I would like to describe as federalism. That is, at a time when the national policies are turning back to the States responsibilities for activities, reducing their grants to States and privatizing activities formerly done by the Government, this measure swims upstream against that tide by decentralizing the Government and making local governments more dependent upon the State than National Government for activities such as sewer, water, schools, or being excluded entirely. For instance, if the city of Prinville wished to have a sewer or water facility, they might find themselves excluded from the market simply because the project would no longer pencil out because of the additional interest cost. Or, the city of Clamouth Falls might find itself excluded from geothermal activity.

Or, we could find a Government being put back into business. For instance, if the State fair wished to offer bonds, which they do, and they lease out certain activities to private food vendors, which they do, they could be prevented from offering bonds under this legislation.

Your goal is a laudable goal—that is, to balance the budget—but this measure doesn't do it. The revenue estimates are questionable, and it simply ignores the lost revenue from jobs and economic activity that are generated by these bonds.

Nor is this measure revenue-neutral as has been suggested. It is only revenue-neutral as to the Federal Government; but as to State and local government, it has a disastrous economic impact.

This committee and this assembly has already done its job in the area of tax-exempt financing. In the last session you placed caps upon the issuance of such bonds. I would suggest that it is time to give that legislation an opportunity to work.

Now, I have to mention one other matter, and that is the pendancy of this legislation alone is damaging to the credit markets, because it has a January 1 effective date. You will find a flood of bonds being presented to the market to get ahead of that date.

I ask you to send a signal of relief to the credit markets so that we do not have to pay a higher price for the necessary offerings and issuances we have.

I want to take just a moment to mention the Mortgage Credit Certificate Act, which was passed by this body in the last session, in which Oregon set up a pilot program, one in which we are ready to proceed to use this Mortgage Credit Certificate Act. In this case, bond allocation is turned into the Treasury and we receive back mortgage credit certificates which will enable first-time home buyers to obtain housing. Under this proposed legislation, that program would be eliminated. The work that the State of Oregon did with the U.S. Treasury would be for naught.

I thank you for the opportunity to appear before you today. Again, I consider it a distinct honor and privilege.

The Chairman. I might just comment on that last point Bill Rutherford made about the credits, the mortgage credits. Oregon didn't think this up, the States didn't think this up, the Treasury suggested it in the tax bill last year. At their request we put it in, and Oregon took advantage of it. Now they want to take it out, and all you do is turn back housing bond authority and issue credits of roughly an equivalent amount, but the Treasury doesn't come out any worse one way or the other. But for all the people who complained about the vagaries of the Federal Government, or moving year-by-year to different tax reforms, and passing and changing and altering, this was a classic example of a catch-22 where we stepped in because they offered it, and now they want to eliminate it.

Treasurer Patterson.

[Mr. Rutherford's written testimony follows:]

BILL RUTHERFORD - STATE TREASURER - STATE OF OREGON

TESTIMONY BEFORE THE SENATE FINANCE COMMITTEE

SEPTEMBER 24, 1985

MR. CHAIRMAN . . . MEMBERS OF THE COMMITTEE . . . MY NAME IS BILL RUTHERFORD AND I AM STATE TREASURER FOR THE STATE OF OREGON. I APPRECIATE THE OPPORTUNITY TO COME BEFORE YOU TODAY.

THERE ARE TWO TOPICS I WISH TO DISCUSS. FIRST, THE PROPOSAL CURRENTLY BEFORE CONGRESS THAT WOULD ELIMINATE THE TAX EXEMPTION FOR MANY STATE AND LOCAL BOND ISSUES. AND SECONDLY, I WANT TO CALL TO YOUR ATTENTION TO PROVISIONS IN THE 1984 TAX REFORM ACT THAT CREATED THE MORTGAGE CREDIT CERTIFICATE PROGRAM. THAT PROGRAM WOULD BE ABOLISHED UNDER THE TAX PROPOSAL SUBMITTED BY THE PRESIDENT.

THE TAX-EXEMPT PRIVILEGE HAS HISTORICALLY BEEN USED FOR MANY BOND PROGRAMS ON THE BASIS THAT THESE PROGRAMS MEET A SIGNIFICANT PUBLIC NEED. THE FEDERAL GOVERNMENT HAS INDIRECTLY SUBSIDIZED THESE PROGRAMS THROUGH THE REVENUE INCENTIVE OF TAX EXEMPTION. PRIVATE INVESTORS RECEIVE THE TAX-EXEMPTION, WHILE GOVERNMENT ENTITIES ENJOY THE BENEFITS OF LOW-COST FINANCING.

BOND PROGRAMS IN OREGON WHICH CURRENTLY ARE GIVEN TAX-EXEMPT STATUS INCLUDE HOUSING PROJECTS FOR THE ELDERLY, THE DISABLED, LOW-INCOME AND ELIGIBLE VETERANS; ENERGY PROJECTS THAT ARE EITHER SMALL-SCALE OR EMPHASIZE THE USE OF RENEWABLE ENERGY; WATER PROJECTS DESIGNED TO DEVELOP A COMMUNITY'S WATER SUPPLY OR INSTALL NEW TREATMENT FACILITIES; IRRIGATION PROJECTS VITAL TO AREAS IN OREGON WHERE WATER MANAGEMENT IS CRUCIAL TO AGRICULTURAL PRODUCTIVITY; AND, PROJECTS DESIGNED TO PROVIDE HOUSING FOR THOSE ATTENDING OREGON'S HIGHER EDUCATION INSTITUTIONS.

THOSE PROJECTS WOULD NOT BE ELIGIBLE FOR TAX EXEMPTION UNDER THE PROPOSED DEFINITION OF "PUBLIC PURPOSE" AS OUTLINED IN THE PRESIDENT'S PROPOSAL. AND YET, WE ALL MUST AGREE THERE IS A NEED TO DEVELOP ALTERNATE ENERGY RESOURCES . . . THERE IS A NEED TO PROVIDE HOUSING FOR THE DISABLED AND THE ELDERLY . . . THERE IS A NEED TO GIVE HELP TO RANCHERS AND FARMERS FOR MANAGEMENT OF CRITICAL WATER SUPPLIES . . . AND THERE IS STILL AN ONGOING NEED TO CONTROL POLLUTION. EACH OF THESE ARE IDENTIFIABLE PUBLIC NEEDS CURRENTLY BEING ADDRESSED BY THE FEDERAL AND STATE TAX-EXEMPTION ON BONDS.

IF WE AGREE THE NEEDS REMAIN AND IF WE TAKE AWAY THE TAX EXEMPTION, WE SHOULD THEN PURSUE ALTERNATIVE MEANS OF GOVERNMENT ASSISTANCE IN MEETING THESE NEEDS.

ALREADY LOCAL GOVERNMENTS ARE OVERBURDENING THE PROPERTY TAX SYSTEM IN OREGON. FOUR TIMES, OREGONIANS HAVE DEFEATED PROPERTY TAX LIMITATION MEASURES . . . BUT ONLY BY THE NARROWEST OF MARGINS. LOCAL GOVERNMENTS WON'T HAVE THE FINANCIAL RESOURCES TO COUNTERBALANCE THE ELIMINATION OF THE TAX EXEMPTION.

THOSE PROJECTS WOULD NOT BE ELIGIBLE FOR TAX EXEMPTION UNDER THE PROPOSED DEFINITION OF "PUBLIC PURPOSE" AS OUTLINED IN THE PRESIDENT'S PROPOSAL. AND YET, WE ALL MUST AGREE THERE IS A NEED TO DEVELOP ALTERNATE ENERGY RESOURCES . . . THERE IS A NEED TO PROVIDE HOUSING FOR THE DISABLED AND THE ELDERLY . . . THERE IS A NEED TO GIVE HELP TO RANCHERS AND FARMERS FOR MANAGEMENT OF CRITICAL WATER SUPPLIES . . . AND THERE IS STILL AN ONGOING NEED TO CONTROL POLLUTION. EACH OF THESE ARE IDENTIFIABLE PUBLIC NEEDS CURRENTLY BEING ADDRESSED BY THE FEDERAL AND STATE TAX-EXEMPTION ON BONDS.

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STATE GOVERNMENT IN OREGON IS IN THE SAME SITUATION. A NEW ECONOMIC FORECAST SHOWS THE STATE TAKING IN OVER $142 MILLION LESS IN TAX REVENUES THAN ORIGINALLY PROJECTED. AS A RESULT, THE ENDING BALANCE FOR THE STATE IS BARE BONES: JUST A LITTLE OVER $5 MILLION. THE STATE DOES NOT HAVE THE FINANCIAL ABILITY TO REPLACE THE TAX EXEMPTION SUBSIDY.

AND WHAT EXACTLY IS THE FEDERAL TREASURY GAINING IF THIS TAX EXEMPTION IS ELIMINATED?

CONGRESSIONAL STAFF ESTIMATE A GAIN TO THE FEDERAL TREASURY OF SIXTEEN BILLION DOLLARS OVER THE NEXT FIVE YEARS. BUT ACCORDING TO AN INDEPENDENT STUDY CONDUCTED BY COOPERS & LYBRAND, THE REVENUES SAVED WOULD BE LESS THAN FOUR BILLION OVER THE SAME PERIOD.

THE DIFFERENCE IN THE ESTIMATES, ACCORDING TO COOPERS & LYBRAND, IS THAT THE COMMITTEE STAFF OVERLOOKED "REFLOW BENEFITS" AND ASSUMED THAT ANY GIVEN PROJECT WOULD STILL BE POSSIBLE WITHOUT TAX EXEMPT FINANCING. "REFLOW BENEFITS" INCLUDE JOBS CREATED BY THE PROJECT, TAXABLE INCOME GENERATED BY THE PROJECT AND SECONDARY EMPLOYMENT SPINNING OFF THE PROJECT. THE POINT IS THAT, WHILE THERE IS A TAX BREAK TO HELP FINANCE THE PROJECT, "REFLOW BENEFITS" ACTUALLY CUT THE COST TO THE TREASURY ANYWHERE FROM 80 TO 95 PERCENT BECAUSE OF INCREASED TAX REVENUES RESULTING FROM THE PROJECT.

BUT WHAT IS THE COST TO LOCAL AND STATE GOVERNMENTS IF THESE CHANGES ARE APPROVED?

IT IS ESTIMATED THAT ELIMINATING THE TAX-EXEMPTION WOULD INCREASE COSTS BY THIRTY PERCENT. THAT KIND OF A COST INCREASE ALMOST SURELY ELIMINATES MANY PROJECTS FROM EVER BEING CONSIDERED.

HOW MANY PROJECTS IN OREGON WOULD BE AFFECTED? LAST YEAR, GOVERNMENTS IN OREGON ISSUED $1.1 BILLION IN TAX EXEMPT BONDS. THE "ONE-PERCENT RULE" WOULD HAVE DENIED TAX EXEMPT STATUS TO OVER NINE HUNDRED MILLION DOLLARS OF THOSE BONDS. ALMOST EIGHTY PERCENT OF ALL PROJECTS IN OREGON THAT WERE FINANCED WITH TAX-EXEMPT DEBT LAST YEAR WOULD NOT HAVE ENJOYED THAT PRIVILEGE UNDER THE TREASURY PROPOSAL.

OREGON HAS USED THE FEDERAL TAX EXEMPTION ON CERTAIN BONDS TO BUILD HOUSING FOR 3600 DISABLED PERSONS . . . WITH TAX-EXEMPT BONDS, WE HAVE PROVIDED HOUSING FOR OVER 1500 ELDERLY FAMILIES . . . OREGON HAS TAKEN ADVANTAGE OF THE TAX EXEMPTION TO PROVIDE CRITICAL WATER MANAGEMENT TO OVER 85,000 ACRES IN OUR STATE . . . AND WE HAVE USED $75 MILLION IN TAX-EXEMPT BONDS TO FINANCE PROJECTS THAT EITHER CONSERVE ENERGY OR PRODUCE ENERGY FROM RENEWABLE RESOURCES. OREGON AND OREGONIANS HAVE USED THAT TAX EXEMPTION, BUT I ASSURE YOU WE HAVE NOT AND WILL NOT ABUSE THAT PRIVILEGE.

WITHOUT THE ADVANTAGES OF LOW-COST FINANCING, MANY WORTHWHILE PROJECTS WILL FALL BY THE WAYSIDE. AND THE BOTTOM LINE IS THAT THERE WILL BE NO LEVEL OF GOVERNMENT WITH THE FINANCIAL ABILITY TO PICK UP THE RESPONSIBILITY TO MEET THOSE IMPORTANT PUBLIC NEEDS.

THE TREASURY PROPOSAL STRIKES AT THE VERY HEART OF FEDERALISM. ESSENTIALLY, THIS PROPOSAL WOULD PREVENT STATES FROM USING TAX-EXEMPT BONDS TO FINANCE CRUCIAL PUBLIC PROJECTS. THE FINAL RESULT OF ELIMINATING THE FEDERAL TAX EXEMPTION IS STATE AND LOCAL GOVERNMENTS BECOMING INCREASINGLY RELIANT ON THE FEDERAL GOVERNMENT. THERE MAY BE A SERIOUS CONSTITUTIONAL CHALLENGE TO THE ELIMINATION OF THIS TAX EXEMPTION, AS WELL.

MY FINAL COMMENTS RELATE TO A RECENT CHANGE IN FEDERAL LAW ALLOWING STATES TO ISSUE FEDERAL TAX CREDITS FOR FIRST-TIME HOME PURCHASERS. IT IS ALSO USEFUL TO STUDY BECAUSE IT IS AN INSTANCE IN WHICH THE FEDERAL GOVERNMENT PROPOSES TO REPLACE TAX EXEMPT FINANCING. UNDER THE PROGRAM AS ESTABLISHED BY THE TAX REFORM ACT OF 1984, A STATE MAY VOLUNTARILY TURN IN A CERTAIN PORTION OF ITS AUTHORITY FOR TAX-EXEMPT HOUSING ISSUES. IN RETURN, THE FEDERAL GOVERNMENT ALLOWS THAT STATE TO USE A MORTGAGE TAX CREDIT CERTIFICATE, ALLOWING A FIRST-TIME HOUEBUYER A FEDERAL TAX CREDIT. IN ESSENCE, THE TAX CREDIT IS USED TO MAKE UP THE DIFFERENCE TO THE HOMEBUYER HAD HE OR SHE FINANCED THEIR PURCHASE THROUGH A PROGRAM USING TAX-EXEMPT FINANCING.

OREGON WAS ONE OF THE FIRST, IF NOT THE FIRST, STATE TO ADOPT ENABLING LEGISLATION TO IMPLEMENT THIS PROGRAM. WE ARE EXCITED ABOUT THE PROSPECTS FOR THE PROGRAM AND STRONGLY BELIEVE IT SHOULD BE CONTINUED.

IF NOTHING ELSE, I HOPE I HAVE ALERTED THIS COMMITTEE TO THE DIRE FINANCIAL STRAITS STATE AND LOCAL GOVERNMENTS ARE IN TODAY AS THEY ATTEMPT TO MEET PUBLIC NEEDS. EVEN THOUGH TAX-EXEMPT FINANCING MAY NOT BE A VERY LARGE TOOL IN ADDRESSING THOSE NEEDS, IT IS ONE OF THE FEW TOOLS WE HAVE LEFT, NOT ONLY TO ADDRESS CONCERNS OF PUBLIC HEALTH AND SAFETY, BUT ALSO TO ATTEMPT TO PROVIDE SOME KIND OF STIMULUS TO THE ECONOMY.

THANK YOU.

## STATEMENT OF HON. GRADY L. PATTERSON, JR., STATE TREASURER, STATE OF SOUTH CAROLINA, COLUMBIA, SC

Mr. PATTERSON. Mr. Chairman and distinguished members of the committee, I also would like to thank you for allowing us to appear in opposition to certain provisions in the President's proposal, Treasury II, which relate to State and municipal bonds. Contained in these proposals are many detrimental provisions which will adversely affect the ability of State and municipal and political subdivisions to fund and finance desirable and worthwhile public projects that provide essential governmental functions for their citizens.

These provisions do violence to the sovereignty of the several States, the 10th amendment to the U.S. Constitution, and the Federal system and are therefore constitutionally impermissible.

In a case that was decided in 1819, Chief Justice Marshall I think stated it beautifully about the federal system—that is, the exemption from taxation "has been sustained on a principle which so entirely pervades the Constitution, is so intermixed with the materials which compose it, so interwoven with its web, so blended with its texture as to be incapable of being separated from it without rending it to shreds."

Now, oftentimes the Federal system is ignored when these tax proposals are brought forward. The federal system is at the core of our constitutional system of government, and the principle is reflected not just in the 10th amendment but is interwoven into the web and structure of our Constitution. And nowhere in our federal system is there a more basic and fundamental right than that of the States and political subdivisions to issue debt free from taxation by the Federal Government. The States are far more than administrative districts operating at the whim of Congress.

Our Founding Fathers feared a strong central government and thus intended the States and local governments would retain sovereignty and counterbalance the tendency toward a powerful central government, thereby eroding our freedom and our liberty.

The constitutional scheme was to divide sovereignty between the two different levels of political entities, the Federal Government and the States. This would prevent undue concentration of power in one government.

Thus, the constitutional basis for the tax exemption of interest earned on State and municipal bonds is in a long line of U.S. Supreme Court decisions; it has been upheld and it is crystal clear.

The single thread that runs through all of these proposals is a calculated assault on tax exemption. The central theme of these proposals points up a sinister purpose—an intent to eliminate tax exemption in the guise of tax reform.

The State and local governments will find their ability to finance governmental services and facilities severely restricted and much more costly if these proposals become law.

The so-called 1-percent rule which has already been alluded to by several witnesses is especially detrimental and repugnant to the financing of desirable and worthwhile projects and facilities. Under the President's proposals on tax-exempt financing, fully 80 percent of the projects currently financed on a tax-exempt basis could no longer be financed on such a basis.

Of far greater significance and import is the fact that these proposals will eliminate or make more difficult general obligation bonds and revenue bond financing for many States and local governments.

There are many other points I want to mention. The tax reform plan penalizes and restricts the State and local officials in the practice of logical and sound cash management, and we are opposed to the denial of deductibility of State and local taxes. And the revenue loss estimates by the Treasury caused by the issuance of tax-exempt bonds is grossly flawed and inaccurate, we think, and that has already been alluded to.

Thankfully, this committee and the Congress have rejected such a tax in the past, and I am sure they will do the same in the future.

I urge this committee to consider the Treasury proposals relating to tax-exempt bonds in the light of the constitutional impermissibility, grossly inaccurate revenue loss, and the continuing bias and mindset of the Treasury against tax-exempt bonds. And I urge this committee to reject same.

In conclusion let me say that in these circumstances please don't do anything for us, because we are afraid if you do, you will do too much to us. [Laughter.]

In conclusion, I want to say that most people come here wanting something; we don't want a thing, Mr. Chairman, we just want to be left alone. [Laughter.]

The CHAIRMAN. You like things just like they are.

Mr. PATTERSON. Yes, Senator. Thank you.

The CHAIRMAN. Mr. Solem?

[Mr. Patterson's written testimony follows:]

THE UNITED STATES OF AMERICA

IN THE COMMITTEE ON FINANCE
THE SENATE

September 24, 1985

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Statement by Grady L. Patterson, Jr., State Treasurer of South Carolina, before the Committee on Finance, United States Senate, on behalf of the National Association of State Auditors, Comptrollers and Treasurers and the State of South Carolina, opposing provisions contained in the President's Tax Proposals (Treasury II) that would alter, modify or destroy the tax-exempt status of interest earned on state and municipal bonds.

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STATEMENT BY GRADY L. PATTERSON, JR., STATE TREASURER OF SOUTH CAROLINA, BEFORE THE COMMITTEE ON FINANCE, UNITED STATES SENATE, SEPTEMBER 24, 1985, OPPOSING CERTAIN PROPOSALS THAT WOULD ALTER, MODIFY OR DESTROY THE TAX-EXEMPT STATUS OF INTEREST EARNED ON STATE AND MUNICIPAL BONDS.

Mr. Chairman, first I want to express my appreciation to the Committee on Finance for this opportunity to be heard in opposition to certain provisions in the President's Tax Proposals (Treasury II) that would alter, modify or destroy the tax exempt status of interest earned on state and municipal bonds.

The President of the United States on May 29, 1985, submitted to congress his tax reform proposals commonly referred as "Treasury II."

Contained in these proposals are many detrimental provisions which will adversely affect the ability of states, municipalities and political subdivisions to fund and finance desirable and worthwhile public projects that provide essential governmental functions for their citizens.

Let me say in the beginning that this Committee has considered similar proposals in the past and has rejected them most of the time.

These provisions do violence to the sovereignty of the several states, the 10th Amendment to the United States Constitution and the Federal System and are therefore constitutionally impermissible.

## LEGAL AND CONSTITUTIONAL BASIS FOR TAX EXEMPTION

Because so many continue to ignore, either through oversight or design, the legal basis for the tax exemption of state and municipal bonds, I think it appropriate to set forth and restate the legal basis for the tax exemption of the interest earned on state and municipal bonds.

The Supreme Court of the United States has spoken to the issue on many occasions. In an early case, Mercantile Bank v. City of New York, 7 Sup. Ct. 826, (1887), in which it said:

> Bonds issued by the State of New York, or under its authority by its public municipal bodies, are means for carrying on the work of the government and are not taxable, even by the United States, and it is not a part of the policy of the government which issues them to subject them to taxation for its own purposes.

Some have argued that the 16th Amendment included authority for the Congress to tax state and municipal bonds.

The text of the 16th Amendment to the United States Constitution is as follows:

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration.

The Amendment became effective in 1913.

In perhaps the first decision of the United States Supreme Court taking cognizance of its ratification, Brushaber v. Union P. R. Co., 36 Sup. Ct. 236, (1915), Chief Justice White for a unanimous Court held:

> It is clear on the face of this text that it does not purport to confer power to levy income taxes in a generic sense,--an authority already possessed and never questioned,--or to limit and distinguish between one kind of income taxes and another, but that the whole purpose of the Amendment was to relieve all income taxes when imposed...from a consideration of the source when the income was derived.

The Chief Justice goes on to point out that the obvious intention of the Amendment was to do away with the principle upon which the case of Pollock v. Farmers' Loan & Trust Co., 15 Sup. Ct. 674, (1895) was decided.

The Pollock case was twice argued in the Supreme Court, and on the principal questions it was decided by a five to four majority. In substance, the majority held that despite the unquestioned right of Congress to levy taxes on income when such income tax was levied upon rents, it was judicially a direct tax upon the real estate from whence the rents were derived. Accordingly, since Congress was prohibited from levying direct taxes by the provisions of Article I, Section 2, Clause 3, unless they be apportioned among the states according to population, such tax was unconstitutional.

When one first reads the 16th Amendment and notes the language permitting the Congress to tax "income from whatever source derived," one's first impression would be that this was intended to permit Congress to tax income from municipal bonds. One has to read further to see that the significant portion of the Amendment is that which permitted this taxation without apportionment among the several states and without regard to any census or enumeration.

Pollock had held that the tax on rent from real property was, in effect, a tax upon the property itself. It was accordingly necessary in order to overcome Pollock to say in so many words that Congress might tax the income from real eetate notwithstanding that it was a direct tax upon real estate. This, and this alone, was the thrust of the 16th Amendment, for it had been unanimously conceded that to tax the income on state bonds was, in effect, an act of taxation by Congress on the states themselves--something that could not be done without destroying the Federal System.

### HISTORICAL BACKGROUND SURROUNDING THE BASIS OF THE SIXTEENTH AMENDMENT

The record surrounding the passage of the 16th Amendment reveals conclusively the intent not to include power or authority for the Federal Government to tax state or municipal securities.

In April 1910, Senator Norris Brown from Nebraska had this to say concerning the question "Shall the Income Tax Amendment be Ratified?":

Recently, the question has been raised by those who

> are opposed to the ratification of the amendment that with the amendment ratified the powers of the States will in some way be impaired and their strength and vitality, in some way not specified, destroyed. The objection is not sound. The amendment in no way changes the existing relation between the State and the Federal Government. Whether the amendment is ratified or not, the rights of the State as a State and those of the Federal Government in their relation to each other will remain the same. Each sovereignty is now wholly independent of the other in the exercise of certain governmental functions, and the proposed amendment neither adds to nor takes away from the independence now enjoyed by each....

Earlier, Senator Joseph W. Bailey, Texas, made the following observation:

> I have also responded to the unanimous decision of the Supreme Court of the United States that Congress has no power to levy a tax upon the incomes derived from state, county and municipal securities, and I have specifically exempted them. I regarded it as unfortunate when the old act was passed that they were then included. I thought it certain, then, that the court would decide--and I think that the court ought to have decided--that part of the old act unconstitutional.
>
> In the early days of the Republic that court, in a decision, announced by its most illustrious member, declared that States, counties and municipalities could not levy a tax upon Federal obligations holding that to permit it would be equivalent to a permission for the States to lay a tax upon the operations and instrumentalities of the Federal Government. I have always believed that decision wise and just; and if it is, then it necessarily follows that its reasoning applies equal forcé against a federal tax upon the operations or instrumentalities of the States and their subdivisions. But even if I doubted that, I would have conformed the amendment to what was the unanimous judgment of the court. (Congressional Report, Vol. 44, Part 2, 61st Congress, 1st Session.)

Senator Borah of Idaho is on record as follows:

I say, therefore, that already Congress is given absolute power; and if the reasoning of the distinguished governor [Hughes, New York] were correct, the language being full and complete, conveying all power, we could tax state bonds and municipal securities and state salaries at the present time.

But there is another controlling reason why we cannot do so, which reason is omitted in the message and which is not affected by this amendment in any manner. The first time the question arose as to power of one sovereignty was in the case of McCulloch v. Maryland. In that case, as all lawyers well remember, there was an attempt on the part of the State of Maryland to tax the stock of the United States Bank. The United States Bank having been organized as an instrumentality of the National Government to carry out certain functions of granted power, it was held that it was not a taxable article. In that case, Chief Justice Marshall considered this question and gave us the basis upon which has been built the entire structure of law which prevents one nationality from taxing the instrumentalities and means of another.

In the first place, it was admitted by the Chief Justice that there was no provision of the Constitution which controlled the subject-matter. It was stated by the Chief Justice that there was neither any limitation nor grant of power which prevented the States from taxing the instrumentalities of the National Government, and he stated in his decision that, therefore, the taxing power of the National Government being complete, the inhibition had to be found somewhere other than that of the taxing clause itself. He said in McCulloch v. Maryland (4 Wheat.):

> There is no express provision [of the Constitution] for that case, but the claim--

That is, the exemption from taxation--

> has been sustained on a principle which so entirely pervades the Constitution, is so intermixed with the materials which compose it, so interwoven with its web, so blended with its texture as to be incapable of being separated from it without rending it to shreds. (Congressional Record, February 10, 1910, p. 1696.)

FEDERALISM

Federalism is at the core of our constitutional system, a principle that is reflected not just in the 10th Amendment but is interwoven into the web and structure of our Constitution. Therefore, it is up to the executive and legislative branches of the Federal Government to recognize and strive to preserve the sovereignty of the several states.

Therefore, if we are to preserve, protect and defend the basic principles of Federalism, this Committee, the Senate and the Congress must ever be alert to proposals that would destroy the Federal System.

Nowhere in our Federal System is there a more basic and fundamental right than that of the states and political subdivisions to issue debt free from taxation by the Federal Government.

The States are far more than administrative districts operating at the whim of Congress. Our founding fathers feared a strong central government and thus intended the states and local governments would retain sovereignty and counterbalance the tendency toward a powerful central government thereby eroding our freedom and liberty.

The Constitutional scheme was to divide sovereignty between two different levels of political entities, the Federal Government and the States. This would prevent undue concentration of power in one government.

Thus, the Constitutional basis for tax exemption of interest earned on state and municipal bonds as expressed in a long line of U. S. Supreme Court decisions is crystal clear.

Moreover, the meaning, intent and purpose of the 16th Amendment were not directed at tax exemption. The evil to be remedied by the 16th Amendment was the adverse effect of the Pollock decision. Beyond any doubt, it (16th Amendment) did not grant Congress any new authority or power to tax state and municipal bonds. The myth about what the 16th Amendment means with respect to state and municiapl bonds should be dispelled and forever laid to rest.

The single thread that runs through all of these proposals is a calculated assault on tax exemption. The central theme of these proposals points up a sinister purpose and intent to eliminate tax exemption in the guise of tax reform.

State and local governments will find their ability to finance governmental services and facilities severely restricted and much more costly if these proposals become law.

## THE SO-CALLED "ONE-PERCENT RULE"

The so-called "one-percent rule" is especially detrimental and repugnant to financing desirable and worthwhile public projects and facilities. If more than one percent of the bond proceeds are used directly or indirectly by a person other than a state or local government, interest on the bonds become taxable.

If a government enters into a management contract with a private firm to operate a facility owned by a state or local government for more than one year, tax-exempt financing is denied because of the private sector's involvement. A solid waste plant or a prison privately owned could not be financed with tax-exempt bonds.

Under the President's proposals on tax-exempt financing, 80 percent of projects currently financed on a tax-exempt basis could not be financed on such basis.

The proposals purport to eliminate tax-exempt bonds for student loans, housing or mortgage revenue bonds, and industrial development bonds.

Of far greater signifigance and import is the fact that these proposals will eliminate or make more difficult general obligation and revenue bond financing for many state and local essential government functions such as water and sewer systems, port facilities and airports. I, therefore, urge the removal of the so-called "one-percent" rule.

## THE MARKET FOR TAX-EXEMPT BONDS ADVERSELY AFFECTED

The market for tax-exempt bonds will be adversely affected by these proposals thereby driving up the expense to taxpayers throughout this country.

The tax reform plan denies the deduction for costs incurred in buying and carrying tax-exempt obligations by banks and financial institutions. Historically, these institutions have been a major purchaser of tax-exempt obligations.

Prior to 1982, a 100% deduction was allowed for such costs, and the elimination of such deduction will drive away and eliminate a large segment of our market for municipal bonds. I urge the removal of the proposal to deny deduction for costs incurred in buying and carrying tax-exempt obligations.

## SEVERELY RESTRICTS CASH AND DEBT MANAGEMENT

The tax reform plan penalizes and severely restricts state and local officials who practice sound and logical cash and debt management.

Any state or local official worth his or her salt will immediately invest the proceeds of a bond sale until the funds are needed to pay for the project. This practice will be severely limited by restricting investment earnings. All earnings in excess of what is permitted (by some treasury bureaucrat) must be rebated to the United States Government. I say this sound practice and procedure is no business of the United States Government. I, therefore, urge the repeal of the arbitrage statute. (Section 103 (C) Internal Revenue Code 1954 as amended.)

## ELIMINATES ADVANCE REFUNDING

The tax reform plan eliminates all advance refunding. I urge the removal of this prohibition from the tax reform proposal.

## IMPOSES ADDITIONAL REPORTING REQUIREMENTS

The proposal extends the IDB reporting requirements to all state and local general obligation and revenue bonds. This proposal is especially repulsive to all who believe in the United States

Constitution, the sovereignty of the several states and the Federal System. Here again, this is no business of the Federal Government. I urge the removal of this requirement.

DEDUCTIBILITY OF STATE AND LOCAL TAXES

The President's proposal to eliminate the deductibility of state and local income, sales and property taxes from an individual's income for purposes of calculating Federal tax liability, would directly affect virtually every taxpayer who itemizes deductions.

Deductibility improves the equity of the Federal income tax by preventing the double taxation of the income used to pay state and local taxes.

By eliminating deductibility, taxpayer resistance to maintaining or increasing current state and local tax levels could make it more difficult for state and local governments to generate needed revenues and continue current levels of service.

I urge the rejection of the President's proposal that would eliminate the deductibility of state and local taxes.

REVENUE LOSS ESTIMATES GROSSLY INACCURATE

Revenue loss estimates by the Treasury caused by the issuance of tax-exempt bonds are grossly overestimated and inaccurate. Treasury placed the loss to the Federal Government because states and local governments issue tax-exempt bonds at approximately $13 Billion over the period 1986-1990.

The Public Securities Association retained the accounting firm of Coopers and Lybrand to perform a study of the Treasury estimates of revenue savings resulting from the municipal bond provisions of Treasury II. Their study completed in August 1985 showed a revenue savings of only $2 Billion.

These grossly flawed and inaccurate estimates by the Treasury brings into sharp focus and question all the data and estimates furnished this Committee and the Congress by Treasury relating to tax-exempt bonds.

I think it points up the continuing bias and mind-set Treasury has against tax-exempt bonds.

Thankfully this Committee and the Congress has rejected most of the attacks by Treasury on tax-exempt bonds. But here they come again in the guise of tax reform with proposals that will virtually eliminate tax exemption of interest earned on state and municipal bonds.

I urge this Committee to consider Treasury proposals relating to tax-exempt bonds in the light of Constitutional impermissibility, gross inaccurate revenue loss, and the continuing bias and mind-set against tax-exempt bonds, and reject them.

## CONCLUSION

In conclusion, this Administration is saying on the one hand that it wants to return authority and responsibility to the states and local political entities, and on the other hand proposing legislation that will severely curtail or destroy the ability of state and local governments to finance essential government functions and projects.

Finally, most people come here wanting something. We don't want a thing. We just want to be left alone.

Respectfully submitted,

Grady L. Patterson, Jr.
State Treasurer of South
Carolina

## STATEMENT BY JAMES J. SOLEM, EXECUTIVE DIRECTOR, MINNESOTA HOUSING FINANCE AGENCY, ST. PAUL, MN; ON BEHALF OF THE COUNCIL OF STATE HOUSING AGENCIES, ACCOMPANIED BY KATHLEEN BOLAND, EXECUTIVE DIRECTOR, MAINE STATE HOUSING AUTHORITY, AUGUSTA, ME

Mr. SOLEM. Thank you, Mr. Chairman.

My colleague Mrs. Boland from the Maine agency and I appreciate the opportunity to talk to the committee about housing and the importance of the Tax Code in the production of the kind of housing that State agencies and local agencies are involved in.

State and local governments and their housing agencies are willing to help respond to the burden the Federal Government is shifting to us in the area of housing programs, but we can't do it without some help from the Congress.

We engage in programs which greatly involve the private sector in producing housing for low- and moderate-income families. The Tax Code is an important part of that joint public-private partnership. The availability of tax-exempt financing for housing is the single most important incentive for the kind of work that we do. We ask that State and local governments retain the ability to use tax-exempt financing for housing programs with a very clear public purpose, and we recognize the need to do a somewhat better job in restructuring these programs and further defining "public purpose."

The Council of State Housing Agencies and the Association of Local Housing Finance Agencies has developed and proposes to the committee and the Congress a series of recommendations which retain tax-exempt financing for housing while at the same time establishing new standards in these housing programs of State and local governments. And I will briefly try to describe these recommendations, but I would ask that a detailed description of these be made a part of the record, Mr. Chairman.

The CHAIRMAN. Your entire statement will be in the record.

Mr. SOLEM. Thank you.

In the area of mortgage revenue bonds for single-family mortgages and home improvement loan programs, the current Federal restriction limits mortgages to no more than 110 percent of the median purchase price for a particular area. We think this number is frequently too high and can be reduced. We propose to lower the house price limitation to 90 percent of the median house price, 110 percent in target areas, and in rural areas use the State median sales price. We think that would significantly lower and target mortgage revenue bond proceeds.

Second, we would suggest that in Federal law you codify the requirement that lower income individuals be served before higher income individuals. There are a variety of mechanisms to do this; virtually all the States have some form for doing that. We urge the adoption of statutory language that will allow the States flexibility to adopt targeting mechanisms which are best suited to their local conditions.

In addition, we recognize the problem of the volume of this debt and the need to make some changes in that area. The position developed by the two issuing organizations advocates the adoption of a flat $16 billion authorization with a 5-percent consumer price index adjustment after 2 years. This would retain the $200 million State floor, and it needs some language to be worked out to develop a formula; but, in short, we recognize the need for limits on the dollar volume, and we propose that to the Congress.

We would also, as the Treasurer of Oregon spoke about, urge that mortgage credit certificates be retained, and adjusted to fit the reforms we are suggesting.

In the area of multifamily, we are suggesting deeper and broader targeting for low-income renters, the codification of the family size adjustment, and standards so that issuing agencies had to monitor and make certain that public-purpose objectives were met for the term of the bonds, the term of the mortgage.

And in addition, we propose in the detailed statement a recommendation which would provide some resources through some additional arbitrage earnings to create a fund for additional income targeting, absent the Federal programs in housing.

Thank you.

The CHAIRMAN. Thank you.

Mr. Tilton.

[Mr. Solem's written testimony follows:]

COUNCIL OF STATE HOUSING AGENCIES

# STATEMENT OF

# JAMES J. SOLEM, EXECUTIVE DIRECTOR

# MINNESOTA HOUSING FINANCE AGENCY

ON BEHALF OF

THE COUNCIL OF STATE HOUSING AGENCIES

BEFORE

THE U.S. SENATE COMMITTEE ON FINANCE

HEARING ON

THE IMPACT OF TAX REFORM

ON TAX EXEMPT FINANCING

SEPTEMBER 24, 1985

STATEMENT OF
JAMES J. SOLEM, EXECUTIVE DIRECTOR
MINNESOTA HOUSING FINANCE AGENCY

ON BEHALF OF
THE COUNCIL OF STATE HOUSING AGENCIES

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MR. CHAIRMAN, MY NAME IS JAMES SOLEM. I AM THE EXECUTIVE DIRECTOR OF THE MINNESOTA HOUSING FINANCE AGENCY AND AM A MEMBER OF THE BOARD OF DIRECTORS OF THE COUNCIL OF STATE HOUSING AGENCIES (CSHA), ON BEHALF OF WHICH I AM SPEAKING TODAY. THE COUNCIL OF STATE HOUSING AGENCIES REPRESENTS THE STATE HOUSING FINANCE AGENCIES OF 49 STATES PUERTO, RICO, THE DISTRICT OF COLUMBIA AND THE VIRGIN ISLANDS. I AM ACCOMPANIED BY MS. KATHLEEN BOLAND. SHE IS THE EXECUTIVE DIRECTOR OF THE MAINE STATE HOUSING AUTHORITY AND IS ALSO ON THE BOARD OF CSHA.

I WOULD LIKE TO BEGIN BY COMMENDING THE COMMITTEE FOR HOLDING THESE HEARINGS TO FURTHER EXPLORE THE RAMIFICATIONS OF TAX REFORM. AS YOUR COLLEAGUES IN THE HOUSE BEGIN THE MARKUP PROCESS, YOUR EXPLORATION OF THE IMPACT OF TAX REFORM TAKES ON INCREASED STATURE. AS YOU ARE AWARE, MR. CHAIRMAN, THE TAX CODE AND ITS USES ARE TIGHTLY WOVEN INTO THE ECONOMIC FABRIC OF OUR SOCIETY. EXACTLY WHAT IMPACT THE REFORMATION OF THE CODE WOULD HAVE IS AS DIFFICULT TO PREDICT AS IT IS IMPORTANT. THIS IS

PARTICULARLY TRUE WITH RESPECT TO LOW-INCOME HOUSING. ECONOMIC FORECASTERS FROM WHARTON ECONOMETRICS, HARVARD AND MIT PREDICT DIRE CONSEQUENCES FOR PRIVATE SECTOR PARTICIPATION IN HOUSING LOW- AND MODERATE-INCOME CITIZENS IF THE PRESIDENT'S TAX REFORM PROPOSAL IS ENACTED. THEIR ANALYSIS CARRIES FURTHER AND PREDICTS A SEVERE NEGATIVE IMPACT ON THE OVERALL ECONOMY. I WOULD LIKE TO REQUEST THAT THIS INVALUABLE STUDY BE MADE A PART OF THE RECORD.

MR. CHAIRMAN, THE FEDERAL DEFICIT HAS RESULTED IN DWINDLING AMOUNTS OF MONEY BEING ALLOCATED FOR HOUSING. COMBINED WITH THE NEW FEDERALISM ADVOCATED BY THE ADMINISTRATION, THE RESULTS ARE STARTLING. THE FY 1986 BUDGET SETS ASIDE ONLY $1.6 MILLION OR LESS THAN TWO TENTHS OF ONE PERCENT FOR HOUSING. WE IN THE STATES STAND WILLING TO SHOULDER THE BURDEN THE FEDERAL GOVERNMENT IS SHIFTING TO US, BUT WE CANNOT DO IT WITHOUT SOME HELP. FEW STATES CAN AFFORD DIRECT APPROPRIATIONS FOR HOUSING, THEIR HOUSING NEEDS ARE PREDOMINANTLY MET BY INDUCING PRIVATE SECTOR PARTICIPATION. TAX CODE INCENTIVES ARE A KEY FACTOR IN THIS AREA.

IN THE CONTEXT OF TAX REFORM YOU WILL BE ANALYZING TAX EXPENDITURES FOR HOUSING THAT RELATE TO BOTH THE DEBT AND EQUITY SIDES OF CAPITAL FORMATION. WITH REGARD TO EQUITY, YOU WILL BE ANALYZING SUCH ITEMS AS ACCELERATED DEPRECIATION, THE "AT RISK" EXCEPTION, AND THE REHAB TAX CREDIT. WE URGE YOU TO CONSIDER THESE AS A PACKAGE OF TAX INCENTIVES FOR HOUSING AND ASK THAT REGARDLESS OF WHAT REFORMS ARE MADE, HOUSING BE GRANTED THE

PREFERENTIAL TREATMENT IT HAS HISTORICALLY RECEIVED. IN PARTICULAR, WE ARE CONCERNED THAT WITHOUT PREFERENTIAL TREATMENT, PRIVATE SECTOR PARTICIPATION IN LOW-INCOME HOUSING WILL ALL BUT DISAPPEAR.

TAKEN IN COMBINATION WITH FAVORABLE TAX TREATMENT ON THE EQUITY SIDE, THE ABILITY TO BORROW BELOW MARKET CAPITAL FOR DEBT FORMATION IS OF VITAL IMPORTANCE. THE AVAILABILITY OF TAX-EXEMPT FINANCING FOR HOUSING IS PERHAPS THE SINGLE MOST IMPORTANT INCENTIVE FOR HOUSING. THE PRESIDENT'S TAX REFORM PROPOSAL CALLS FOR THE ELIMINATION OF BOTH TAX-EXEMPT FINANCING FOR FIRST-TIME HOMEBUYERS -- THE MORTGAGE REVENUE BOND PROGRAM -- AND TAX-EXEMPT FINANCING FOR LOW-INCOME MULTIFAMILY RENTAL HOUSING -- THE MULTIFAMILY INDUSTRIAL DEVELOPMENT BOND PROGRAM. WE BELIEVE, AS DO THE AUTHORS OF THE EARLIER REFERRED TO ECONOMIC STUDY, THAT TO FOLLOW THIS COURSE WILL RESULT IN A DRAMATIC DROP IN THE STOCK OF HOUSING AVAILABLE TO LOW- AND MODERATE-INCOME AMERICANS. WE ASK THAT THEY BE RETAINED. WE ARE, HOWEVER, COGNIZANT OF THE FACTS THAT FISCAL RESPONSIBILITY DEMANDS A TIGHTENING OF THE FEDERAL PURSE STRINGS AND THAT CURRENT LAW TAX-EXEMPT FINANCING PROGRAMS DO ENCOUNTER SOME ABUSES. THEREFORE, WE COME BEFORE YOU TODAY WITH A PROPOSAL, ENDORSED BY THE ASSOCIATION OF LOCAL HOUSING FINANCE AGENCIES, WHICH RETAINS TAX-EXEMPT FINANCING FOR HOUSING WHILE AT THE SAME TIME TIGHTENS THE PROGRAMS SO THAT THEY ARE MORE EFFICIENT, RESPONSIBLE USERS OF FEDERAL FUNDS.

## MORTGAGE REVENUE BONDS (MRBS)

THE MORTGAGE REVENUE BOND PROGRAM WHICH IS AUTHORIZED BY CODE SECTION 103(A) WAS RENEWED LAST YEAR, THROUGH 1987. THE PROGRAM ALLOWS THE ISSUANCE OF TAX-EXEMPT BONDS, THE PROCEEDS OF WHICH ARE THEN USED TO PROVIDE BELOW MARKET MORTGAGE MONEY FOR MODERATE-INCOME FIRST-TIME HOMEBUYERS.

THE LIMITATIONS PLACED UPON THIS MONEY ARE THAT THE BENEFICIARIES CANNOT HAVE HAD AN INTEREST IN A RESIDENCE DURING THE PRIOR THREE YEARS. FURTHER, THE MORTGAGES MUST BE USED TO PURCHASE HOMES WHICH WILL BE THE BUYER'S PRINCIPLE RESIDENCE AND WHICH COST NO MORE THAN 110% OF THE MEDIAN AREA PURCHASE PRICE (120% IN TARGET AREAS). OUR RESEARCH HAS SHOWN THAT THIS WIDELY USED AND VERY SUCCESSFUL PROGRAM COULD BE BETTER TARGETED. IN SOME INSTANCES, THE 110% OF AREA MEDIAN PURCHASE PRICE LIMITATION ALLOWS BUYERS TO USE MRB MORTGAGES TO BUY HOMES IN AS HIGH AS THE 73RD PERCENTILE RANGE OF ALL AREA HOME SALES. WE PROPOSE TO LOWER THE LIMITATION TO 90% (110% IN TARGETED AREAS). THIS REDUCTION WOULD RESULT IN MRB FINANCED LOANS BEING USED TO PURCHASE HOMES IN THE MEDIAN RANGE OF AREA HOME SALES PRICES; A MUCH MORE REASONABLE PRICE RANGE FOR USE OF A FEDERAL SUBSIDY. WE WOULD SUGGEST THAT IN LOW-INCOME RURAL AREAS, THE STATE MEDIAN INCOME BE ESTABLISHED AS THE STANDARD.

DURING THE MRB REAUTHORIZATION PROCESS LAST YEAR, CONCERN WAS EXPRESSED BY MEMBERS OF THIS COMMITTEE THAT THE PROCEDURES USED BY ISSUING AGENCIES TO PROCESS LOAN APPLICATIONS COULD BE BETTER ORGANIZED. IT WAS NOTED THAT RATHER THAN ALLOWING LOANS TO BE ISSUED ON A FIRST COME FIRST SERVE BASIS TO QUALIFIED CANDIDATES, SYSTEMS COULD BE SET UP SO THAT LOWER INCOME QUALIFYING CANDIDATES WERE GIVEN LOANS PRIOR TO THOSE OF HIGHER INCOMES. CSHA AGREES WITH THIS CONCEPT AND WOULD LIKE TO SEE STATUTORY LANGUAGE DEVELOPED SO THAT SUCH SYSTEMS WOULD BE MANDATORY. IN FACT, A NUMBER OF OUR STATES HAVE SUCH SYSTEMS. NEW YORK AND COLORADO HAVE SYSTEMS OF LOAN APPLICATION PRIORITIZATION DONE AT AN ADMINISTRATIVE LEVEL. ARKANSAS MAKES THE LOAN MONEY AVAILABLE IN STAGES TO LOWER INCOME HOMEBUYERS FIRST. WE ARE HOPEFUL THAT STATUTORY LANGUAGE WILL BE ENACTED AND THAT IT WILL ALLOW THE STATES THE FLEXIBILITY TO ADOPT SYSTEMS BEST SUITED TO THEIR ORGANIZATIONS.

CURRENT LAW RESTRICTS THE VOLUME OF TAX-EXEMPT MRBS A STATE CAN ISSUE TO THE GREATER OF $200 MILLION OR A ROLLING AVERAGE OF A STATE'S PRIOR THREE YEARS TOTAL MORTGAGE INITIATION. UNDER THIS FORMULA TOTAL VOLUME ALLOCATION FOR THE PROGRAM WILL APPROACH $20 BILLION IN 1986. THIS AMOUNT IS SIMPLY TOO HIGH. CSHA ADVOCATES THE ADOPTION OF A FLAT $16 BILLION AUTHORIZATION WITH A 5% CPI ADJUSTMENT AFTER TWO YEARS. UNDER THIS PROPOSAL, THE $200 MILLION STATE FLOOR WOULD REMAIN. WE ARE IN THE PROCESS OF DEVELOPING A FORMULA FOR THE REMAINING ALLOCATION, AND LOOK

FORWARD TO WORKING WITH THE COMMITTEE ON THIS ISSUE. NATURALLY, THE CURRENT LAW MORTGAGE CREDIT CERTIFICATE PROGRAM WOULD BE ADJUSTED TO FIT THE REFORMED PROGRAM AND RETAINED.

WE BELIEVE THAT WITH THESE CHANGES THE MRB PROGRAM WILL BE A SIGNIFICANTLY BETTER TARGETED SUBSIDY THAN IT IS CURRENTLY. WE ASK THIS COMMITTEE TO CONSIDER REMOVING THE SCHEDULED 1987 SUNSET DATE THEREBY MAKING THIS IMPORTANT HOMEOWNERSHIP PROGRAM A PERMANENT PART OF THE TAX CODE AND NATIONAL HOUSING POLICY.

## MULTIFAMILY RENTAL HOUSING
## INDUSTRIAL DEVELOPMENT BONDS (IDBS)

CURRENT LAW ALSO ALLOWS STATE AND LOCAL AUTHORITIES TO ISSUE TAX-EXEMPT BONDS FOR THE DEVELOPMENT OF LOW- AND MODERATE-INCOME MULTIFAMILY RENTAL HOUSING. IN ORDER TO QUALIFY FOR TAX-EXEMPT FINANCING, 20% OF THE APARTMENTS BUILT MUST BE AVAILABLE TO FAMILIES WHOSE INCOMES DO NOT EXCEED 80% OF THE AREA MEDIAN. SINCE ITS INCEPTION THIS PROGRAM HAS RESULTED IN THE DEVELOPMENT OF MORE THAN 1 MILLION RENTAL UNITS FOR LOW-INCOME FAMILIES. WITH THE CONTINUING PHASE OUT OF HUD APPROPRIATIONS, THIS PROGRAM IS WIDELY ACKNOWLEDGED AS "THE ONLY GAME IN TOWN".

THERE ARE DRAWBACKS, HOWEVER. FIRST, A BALANCE MUST BE CREATED BETWEEN PUBLIC PURPOSE GOALS AND PRIVATE SECTOR INVOLVEMENT. OBVIOUSLY WHENEVER THE PRIVATE SECTOR IS INVOLVED A

PROFIT MARGIN MUST BE REALIZED. THERE IS ONLY SO MUCH TARGETING THAT A DEVELOPMENT CAN BARE AND STILL HAVE THE PROJECT BE ECONOMICALLY FEASIBLE.

SECONDLY, AND OF EQUAL IMPORTANCE, THERE ARE PROJECTS THAT ABUSE THE PRIVILEGE OF TAX-EXEMPT FINANCING. THERE ARE PROJECTS THAT FOLLOW THE "LETTER" OF THE LAW BUT NOT ITS SPIRIT. HOWEVER, IT IS IMPORTANT TO NOTE THAT A RECENT STUDY BY THE GAO BORE WITNESS TO THE FACT THAT THE VAST MAJORITY OF THE PROJECTS FALL WELL WITHIN THE "PUBLIC PURPOSE" STANDARDS SET FORTH BY CONGRESS. I REFER THE COMMITTEE TO THE TRANSCRIPT OF RECENT HEARINGS HELD BY THE OVERSIGHT SUBCOMMITTEE OF THE HOUSE WAYS AND MEANS COMMITTEE WHICH EXPLORED THIS SUBJECT (JUNE 21 AND AUGUST 1, 1985).

AS A RESULT OF THOSE HEARINGS AND THE PRESIDENT'S TAX REFORM PROPOSAL, CSHA HAS EXAMINED THE MULTIFAMILY RENTAL PROJECTS OF ITS MEMBERS AND OFFERS THE FOLLOWING REFORMS OF THE CURRENT LAW IDB PROGRAM.

FIRST, WE BELIEVE THAT THERE IS FURTHER TARGETING THAT CAN BE APPLIED. OUR MEMBERS' EXAMINATION OF THEIR DEVELOPMENTS LEADS TO THE CONCLUSION THAT THEY CAN TAKE EITHER DEEPER OR BROADER TARGETING TO LOW-INCOME CITIZENS. ACCORDINGLY, WE RECOMMEND THAT CONGRESS SET STANDARDS UNDER WHICH TAX-EXEMPT FINANCED RENTAL PROJECTS WOULD BE REQUIRED TO EITHER SET ASIDE

30% OF THEIR UNITS FOR RENT BY PEOPLE AT 80% OF AREA MEDIAN INCOME OR SET ASIDE 20% OF THE UNITS FOR PEOPLE AT 70% OF AREA MEDIAN. IT IS IMPORTANT TO NOTE THAT ALTHOUGH CSHA TRIED TO REACH ONE STANDARD FOR FURTHER TARGETING LEVELS, THIS WAS VIRTUALLY IMPOSSIBLE. LOCALIZED MARKET CONDITIONS VARY TO SUCH EXTREMES THAT NO ONE STANDARD COULD BE AGREED UPON. WE ARE CONFIDENT THOUGH, THAT BY ADOPTING FURTHER TARGETING REQUIREMENTS TO LOCAL MARKETS, AS WE HAVE DONE, A GREATER PUBLIC PURPOSE WILL BE MET, WHILE AT THE SOME TIME, ECONOMIC FEASIBILITY WILL BE MAINTAINED.

THE GAO STUDY INDICATED THAT ONE OF THE MOST SERIOUS ABUSES OF THE PROTRAM OCCURS IN THE WAY DEVELOPERS ADJUST FOR FAMILY SIZE. GAO HAS RECOMMENDED THAT REGULATORY STANDARDS BE ESTABLISHED, AND TREASURY IS IN THE PROCESS OF DOING SO. CSHA ENDORSES THE CODIFICATION OF FAMILY SIZE ADJUSTMENT. TO DO SO WOULD FORCE DEVELOPERS TO ESTABLISH RENTS FOR THE LOW-INCOME SET ASIDE UNITS BASED ON FAMILY SIZE, INCOME AND UNIT SIZE ASSUMPTIONS. CURRENTLY RENTS CAN BE ESTABLISHED BY ASSUMING OCCUPANCY BY A FAMILY OF FOUR REGARDLESS OF THE SIZE OF THE APARTMENT. WE SUGGEST THAT THE FOLLOWING FAMILY SIZE ADJUSTMENT SCHEDULE, SIMILAR TO THE ONE USED UNDER THE SECTION 236 PROGRAM, CAN BE REASONABLY APPLIED TO THIS SHALLOW SUBSIDY PROGRAM.

| | | |
|---|---|---|
| EFFICIENCY | 1 PERSON | 56% OF MEDIAN |
| 1 BEDROOM | 2 PEOPLE | 64% OF MEDIAN |
| 2 BEDROOM | 4 PEOPLE | 80% OF MEDIAN |

| | | |
|---|---|---|
| 3 BEDROOM | 6 PEOPLE | 85% OF MEDIAN |
| 4 BEDROOM | 8 PEOPLE | 90% OF MEDIAN |

UNDER THIS STANDARD DEVELOPERS WOULD BE ABLE TO ASSUME LARGER, YET NOT UNREASONABLY LARGE, FAMILY SIZES, WITH COMMENSURATELY HIGHER INCOMES; THEREBY MAKING THE DEVELOPMENTS ECONOMICALLY FEASIBLE.

WHEN TAKEN IN CONJUNCTION WITH THE PREVIOUSLY DETAILED FURTHER RESTRICTIONS ON INCOME, THE IDB PROGRAM WILL BE FACING TARGETING TO AS LOW AN INCOME LEVEL AS IS POSSIBLE.

THIRDLY, WE HAVE FOUND THAT MANY DEVELOPERS ATTEMPT TO SATISFY THE 20% SET ASIDE REQUIRFMENT BY DESIGNATING EFFICIENCY UNITS AS THEIR 20%. WE THEREFORE SUGGEST THAT BEDROOM PROPORTIONALITY SHOULD BE REQUIRED IN TAX-EXEMPT FINANCED PROJECTS. UNDER THIS PLAN A DEVELOPER WOULD BE FORCED TO SET ASIDE AS LOW-INCOME UNITS, A GREATER THAN OR PROPORTIONATE NUMBER OF TWO OR MORE BEDROOM UNITS AS ARE IN THE DEVELOPMENT AS A WHOLE. THIS PROPOSAL WILL NOT ONLY ELIMINATE THE ABUSE, BUT WILL ALSO ENCOURAGE DEVELOPERS TO BUILD MORE MULTI-BEDROOM UNITS, WHICH WILL HELP ALLEVIATE THE CRISIS IN LOW-INCOME HOUSING FOR LARGE FAMILIES. WE MUST, HOWEVER, RECOMMEND THAT AN EXCEPTION BE ALLOWED FOR DEVELOPMENTS OF LESS THAN 50 UNITS. SUCH SMALL PROJECTS, WHICH ARE CUSTOMARILY BUILT IN RURAL AREAS, WOULD HAVE TROUBLE MEETING THIS BEDROOM PROPORTIONALITY REQUIREMENT AND

STILL BE ECONOMICALLY FEASIBLE.

THE NEXT PORTION OF OUR PROPOSAL IS NOT AIMED AT THE DEVELOPERS, OR AT THE BENEFICIARIES, BUT AT OURSELVES. WE ARE AWARE THAT IT IS IMPERATIVE THAT THE ISSUERS OF TAX-EXEMPT BONDS BE HELD TO CERTAIN STANDARDS OF RESPONSIBILITY. WE ARE ALSO AWARE THAT RESPONSIBLE ISSUERS NEED THE AUTHORITY TO ENABLE THEM TO MONITOR THE PROJECTS WHICH WE ARE FINANCING. WE THEREFORE SUGGEST THAT LANGUAGE BE DEVELOPED WHICH WILL SET ISSUER STANDARDS AND RESPONSIBILITIES AND WHICH WILL EMPOWER ISSUERS WITH CERTAIN MONITORING AUTHORITY. FOR EXAMPLE, WE HOPE THAT THE ANNUAL POLICY STATEMENT, CURRENTLY REQUIRED UNDER THE MRB PROGRAM WILL BE MADE AN ACROSS THE BOARD REQUIREMENT FOR ALL HOUSING BOND ISSUANCES.

IF THE ABOVE OUTLINED SUGGESTIONS ARE ADOPTED, THE MEMBER AGENCIES OF CSHA FEEL THAT AN EFFICIENT SHALLOW SUBSIDY HOUSING PROGRAM WILL BE MADE EVEN MORE SO. WE BELIEVE THAT OUR PROGRAMS WILL BE AS EFFICIENT AS POSSIBLE AND REACH TO AS LOW AN INCOME GROUP AS IS FEASIBLE. WE FREELY ADMIT THAT THIS PROGRAM DOES NOT REACH PEOPLE OF EXTREMELY LOW INCOMES. IT SIMPLY CANNOT. IT DOES NOT RECEIVE THE FEDERAL SUBSIDY REQUIRED TO REACH BELOW THE LEVELS THAT THIS INCREASED TARGETING WILL REACH. SHOULD THIS COMMITTEE BE SEARCHING FOR AN INDIRECT SUBSIDY PROGRAM TO REPLACE THE HUD SECTION 8 PROGRAM WE RECOMMEND THE FOLLOWING.

ALLOW ISSUING AGENCIES THE OPTION OF INCREASING THEIR ARBITRAGE EARNINGS BY 25 BASIS POINTS. ALL OF THESE INCREASED EARNINGS WOULD BE SET ASIDE IN A HOUSING TRUST FUND TO BE INVESTED (RESTRAINED BY THE USUAL FIDUCIARY RESPONSIBILITIES) AND EARMARKED TO EITHER BUY DOWN THE MORTGAGES OF THE LOWEST QUALIFYING MRB USERS, OR BE APPLIED TO DECREASE FURTHER THE RENTS FOR THE LOW-INCOME TENANT OF THE MULTIFAMILY RENTAL PROJECTS. THROUGH SUCH A TECHNIQUE, LOWER INCOME HOMEBUYERS AND RENTERS COULD BE HELPED, UNDER THE AUSPICES OF A RESPONSIBLE STATE AGENCY AND AT LESS COST TO THE FEDERAL GOVERNMENT. NOTWITHSTANDING THE NEGATIVE REACTION THAT ARBITRAGE INSPIRES, WE URGE THE COMMITTEE TO CONSIDER THIS SUGGESTION.

STATE HOUSING FINANCE AGENCIES ARE IN THE UNENVIABLE POSITION OF BEING THE MIDDLE MAN IN THE PROCESS OF CREATING PRIVATE SECTOR-PUBLIC SECTOR PARTNERSHIPS FOR HOUSING. WE BELIEVE THAT WE ARE EXCELLING ONLY WHEN THE PRIVATE SECTOR DEVELOPERS ARE COMPLAINING THAT WE HAVE PUSHED THEM TOO FAR, WHILE AT THE SAME TIME CONGRESS AND LOW-INCOME ADVOCATES ARE URGING US TO GO FARTHER. GIVEN THAT SCENARIO, IT IS FAIR TO SAY THAT THE PROPOSAL WE HAVE PLACED BEFORE YOU TODAY ACCOMPLISHES THAT GOAL; NAMELY CONTINUATION OF A PRIVATE SECTOR PROGRAM BETTER TARGETED TO SERVE PUBLIC PURPOSE.

THANK YOU FOR YOUR TIME. MY COLLEAGUE AND I ARE PREPARED TO ANSWER ANY QUESTIONS YOU MAY HAVE.

## STATEMENT BY JESSE C. TILTON III, GENERAL MANAGER, INDIANA MUNICIPAL POWER AGENCY, INDIANAPOLIS, IN

Mr. TILTON. Thank you, Mr. Chairman.

I am general manager of Indiana Municipal Power Agency. I am here today representing both IMPA and our national association, the American Public Power Association, representing approximately 1,750 local publicly owned electric utilities nationwide.

IMPA is a political subdivision of the State of Indiana, created by 25 Indiana cities and towns to provide electricity to them for their 250,000 citizens.

Public power is a traditional governmental function and a public-purpose issuer of tax-exempt bonds. In Indiana and throughout this country, community-owned electric utility systems date back to the inception of central-station electric service in the early 1880s. IMPA jointly owns a 625-megawatt coal-fired generating facility with a private entity, Public Service Company of Indiana, and has issued $143 million in tax-exempt revenue bonds to finance this interest.

The President's May 1985 tax proposals, however, would severely restrict the issuance of such tax-exempt bonds by State and local governments and increase their costs significantly. Under the proposed 1-percent rule, the interest on obligations issued by a State or local government would be taxable if more than 1 percent of the proceeds were used directly or indirectly by a nonexempt person.

Generally, use of a facility financed with the proceeds of tax-exempt obligations would be considered to be "use of the proceeds." IMPA, like many public power systems, is currently unable to use the entire output from its share of the coal-fired generating plant that I described previously. Therefore, IMPA has made arrangements to sell a portion of the power to a private entity. In a few years, however, the agency will reclaim this power.

IMPA's arrangement is sound management of public resources, for several reasons. First, the public power systems can provide for planned growth in an efficient manner; second, by selling excess capacity available during the early years of a new facility's operation, utilities can take advantage of the economies of scale inherent in electric generation and maximize efficient use of the Nation's electric energy system; and third, generating resources do not remain idle, and the cost of electric power to all consumers is lowered.

The President's proposed 1-percent limit would make it virtually impossible for publicly owned electric systems to continue following these sound utility practices.

Finally, the proposed 1-percent limit is arbitrary and ignores the basic economic and technical realities of providing electric energy from publicly owned facilities. It would also reduce the financial viability of publicly owned utilities, thereby reducing competition in the industry and fostering the distorted effects of monopoly power.

A second area of serious concern to IMPA and public power is the broad wording of the prohibition on long-term management contracts. Tax-exempt financing could not be used for facilities managed under contract by a nongovernmental person for more than 1 year.

In drafting our joint ownership contract with Public Service of Indiana, a question arose over who would manage the plant. Because Public Service was the majority owner and already had a trained staff capable of operating a large complex facility, they were designated as the plant managers. This contract, however, does not entitle the private utility to use or benefit from the agency's ownership interest. Nevertheless, as we interpret the broadly defined management contract provision of the tax proposal, public power systems would be prevented from entering into prudent and justified contracts of the type I have just described.

Moreover, this would effectively kill joint ownership of electric generating plants, and ultimately consumers would pay higher bills.

The third issue is the further restriction of State and local government use of arbitrage. Under a recent tax reform law, publicly owned utilities have limited arbitrage opportunities. These revenues are used to reduce the cost of construction and the amount of tax-exempt financing issued.

The proposed unrealistic criteria of spending a specific and significant amount of the proceeds over short time periods has no relation to the size and construction schedules of projects.

The fourth issue is the prohibition on all advanced refundings of tax-exempt bonds. The blanket prohibition of advanced refundings would limit an issuer's ability to take advantage of lower interest rates, to restructure debt service, to match a changing revenue scheme.

Just let me conclude, please, Senator.

The final issue that we wanted to address was the transition rules. There are a number of State and local governments who have projects that are approved, and we are very concerned that those be allowed to go forward.

[Mr. Tilton's written testimony follows:]

United States Senate Finance Committee
Hearings on Chapter 11 (Municipal Tax Exempt Bonds)
of Presidents Tax Proposals

September 24, 1985

Testimony of:

Jesse C. Tilton III
General Manager
Indiana Municipal Power Agency

I am Jesse C. Tilton III. I have been the General Manager of the Indiana Municipal Power Agency (IMPA), 5920 Castleway West Dr., Suite 118, P.O. Box 50700, Indianapolis, Indiana 46250 since March 1982.

I am here today to testify in support of the retention of tax exemption on the interest of municipal debt issued to finance the traditional governmental purpose of public power and to ask that certain restrictions advanced by the President's Proposals which would inhibit issuance of tax free debt for public power purposes be eliminated. Particularly I ask that this Committee not report a bill out unless:

i. It retains the so-called 25% rule - that is the provisions of present law under Section 103 of the Internal Revenue Code of 1954 which preserves the tax exemption of an issue as long as not more than 25% of the proceeds of that issue benefit a non-exempt entity,

ii. It allows tax exemption under a contract management arrangement where actual operations of a jointly owned utility facility is performed by an investor owned utility under a contract for the life of the unit, and

iii. It retains arbitrage and advance refunding procedures of existing law which already incorporate restrictions adopted over the past several years.

## I. Summary of IMPA Position

1) IMPA is a political subdivision of the State of Indiana organized in 1980 to provide the electric power and energy requirements of its city and town members. Presently, 25 cities and towns in Indiana take all of their electric requirements from the Agency, serving about 250,000 inhabitants at over 130,000 residential, commercial and industrial customer sites.

2) The providing of municipal electric service by IMPA's member cities and towns can be traced as an important and traditional government function as far back as 1881.

3) IMPA issued tax exempt debt of $143 million in 1983 to finance the acquisition of a 25% ownership interest in a 625 MW coal fired generating facility near Princeton, Indiana, from Public Service Company of Indiana, Inc., and plans to issue future tax exempt debt to acquire both transmission and additional electric generation facilities to meet the current and projected electric needs of its members.

4) IMPA supports the preservation of tax exemption for bonds for such traditional governmental purposes as public power. Such purposes include its issuance of debt to acquire generation and transmission for the joint use of all its members and its individual members' issuance of debt to finance their individually owned retail distribution facilities.

5) Realistically, reducing to 1% from 25% the amount of an issue that may be expended for non-governmental purposes, as proposed, has the same effect in many instances of entirely taking away the right to issue tax exempt bonds in connection with the acquisition of very expensive electric generating and transmission facilities.

6) Consequently, IMPA believes the existing 25% rule should be preserved since it benefits the ratepayer and is needed in order for the joint agency and its member cities and towns to perform the traditional governmental function of providing electricity.

7) Municipal and joint agency ownership in large electric generating and transmission facilities is dependent upon the operation and management of such facilities by the investor-owned utility owning a majority of such facility. Such a utility already has the manpower and expertise in place to provide such operation and management.

8) Consequently, Congress should not enact a law which would remove the tax exemption for any issue the proceeds of which will be used to buy generation or transmission for which the investor-owned utility will provide long-term management services.

9) Congress should not change present rules concerning arbitrage or advance refunding. Too many changes in municipal tax exempt financing laws have recently been made. No further changes in the tax laws should be made until the impact upon existing laws are absorbed by the cities and the administration has evaluated the effects of these recently enacted statutes.

## II. Nature of IMPA And Its Members

IMPA is a political subdivision of the State of Indiana created pursuant to IC 8-1-2.2 in 1980 by its member cities and towns to provide a part of the cities' and towns' traditional governmental function of planning for and owning facilities to generate the electricity requirements of its 25 participating members.[1] Each of its member municipalities provides electricity at retail as a governmental service along with other governmental services such as police, fire, roads, and sewers. The Agency includes both medium sized cities such as Anderson, Indiana (population 64,695) and

[1] Anderson, Bargersville, Centerville, Covington, Crawfordsville, Darlington, Flora, Frankfort, Frankton, Greendale, Greenfield, Jamestown, Lawrenceburg, Lebanon, Linton, Middletown, Paoli, Pendleton, Peru, Rensselaer, Richmond, Rising Sun, Scottsburg, Tipton, Washington.

Richmond, Indiana (population 41,349) and towns as small as Darlington, Indiana (population 811) and Jamestown, Indiana (population 924). In all, the Agency provides electricity to about 250,000 people in Indiana and to more than 130,000 residential, commercial and industrial customer sites. In 1984 the Agency had operating revenues of $125.7 million.

The provision of municipal electric service in Indiana can be traced as an important function of city government as far back as 1881. In that year Rensselaer commenced operating one of the very first municipal electric plants in the state. Municipal electric systems were also started by Anderson in 1897, Crawfordsville in 1890, Lawrenceburg in 1900, Richmond in 1902, and Washington in 1906. The other IMPA cities have similar histories although three also commenced service during the later depression years of the 1930s. Well prior to the turn of the twentieth century, Indiana cities had issued debt for the purpose of paying for municipal utility plants.(2)

In 1983 the Agency issued revenue bonds in the amount of $143 million that bore interest that was tax exempt under Section 103 (a) of the Internal Revenue Code of 1954, as amended, ("Code"). The proceeds were primarily used to purchase a 25% undivided ownership interest in the Gibson Unit No. 5 electric generating facilities in southwestern Indiana from Public Service Company of Indiana ("PSI"). The 625 MW unit's state of the art environmental equipment allows it to burn Indiana coal. The output of this generating unit, along with purchased power and the output from certain member owned generation provides the power supply for all the Agency's participating members. Largely because Gibson Unit No. 5 could be acquired with the proceeds of tax-free debt, the members were able to demonstrate to the Public Service Commission of Indiana (PSCI) and obtain its certification, in a proceeding required by statute before the PSCI, that the Agency would be able to provide the members

(2) The Rushville Gas Company vs City of Rushville, 1889, 121 Ind. 206.

and ultimately their retail ratepayers with cheaper electricity than the members could provide their retail ratepayers if they continued to purchase power at wholesale from Indiana's investor-owned utilities.[3]

## III. The Impact of the Proposals

Chapter 11 of the Proposals will reduce the benefits from joint ownership of electric generating facilities to agencies such as IMPA and consequently the benefits to their member cities and towns. Independently, individual cities and towns will also lose benefits. The direct impact of Chapter 11 of the Proposals, if enacted, will result in higher retail rates for electricity in Indiana cities and towns as well as for other cities and towns across the country.

Electric rates will increase because the Agency will be prevented by the Proposals from duplicating another acquisition with the same economic benefits as Gibson 5. Not only will joint agencies such as IMPA suffer from the Proposal's negative impact upon tax-exempt financing, but the Agency's members - the Indiana cities and towns - will also suffer independently when they sell separate distribution related bond issues if tax exempt status for these issues is denied. The cities and towns may thus doubly feel the consequences of the Proposals. In addition certain other sections of the Proposals will also increase the costs of tax-exempt financing.

IMPA does not oppose tax reform or the correction of abuses in the tax exempt bond area. It does, however, believe that the benefits of tax exempt

[3] The difference in cost to an issuer of taxable utility bonds and exempt municipally issued bonds has historically been about 2 to 3 percentage points (200 to 300 basis points). This difference in cost - attributed to federal taxing policy - was a significant part of the evidence offered to the PSCI to support certification of the project.

financing should be preserved in the municipal power area.[4] Thus, IMPA asks that each of the following components of the Proposals in Chapter 11 be rejected:

(1) adoption of the 1% rule and elimination of the 25% rule (page 285)

(2) long-term management contract resulting in loss of tax exemption (page 285)

(3) loss of arbitrage (page 291)

(4) loss of advance refunding (page 291)

(5) reporting requirements (page 286)

(6) restrictive transition rules

Any part of the Proposals which Congress adopts should provide reasonable transition rules allowing the tax-exempt financing of projects initiated before changes in the law are adopted.

IMPA believes its requests are reasonable and result in greater fairness and equity to cities and towns and joint agencies developing electric power and transmission facilities. First, cities and towns have suffered substantial reductions in federal benefits over the past several years, including the initial limitations on IDB's (Industrial Development Bonds) enacted in 1968 and increasing legislative impairments on IDB use every few years including the enactment of the 1984 Tax Reform Law. Efforts to reduce the impact of big government and reduce federal spending have also been extremely harsh on cities and towns. Many federally financed benefits,

[4] The Sixteenth Amendment to the United States Constitution may be interpreted so as not to authorize taxation of interest on state and local obligations. See State of South Carolina v. Donald T. Regan, 1984, ___U. S.___, 104 S.Ct. 1107; Robinson, "Minimum Tax On Income That Includes Interest On State And Municipal Obligations Would Be Unconstitutional," 1982 Municipal Finance Journal 83.

including revenue sharing programs, have been greatly curtailed or eliminated under the past administration. Basic fairness would seem to demand that further sacrifices not be made by cities and towns until the rest of the country - including those industries and groups representated by powerful lobbying interests - make similar sacrifices.

Other provisions of the President's Proposals also impact adversely on the ability to issue tax exempt municipal debt. For example, the reduction in maximum tax rates may reduce demand for tax exempt issues. The proposal to deny a deduction for interest to carry tax exempt bonds (Chapter 10.02 of the Proposals) will further curtail demand. Consequently, not only have past federal legislative actions curtailed a city's ability to provide financing for needed public improvements, but also other parts of the Proposals (other than those from which IMPA seeks specific relief) adversely impact upon the cities' financing ability. Municipalities, both during the past and by these Proposals, suffer far more than their fair share.

Laws enacted over the past several years substantially restrict the volume of IDB's and restrict tax-exempt bonds in a fashion designed to limit their use. Further intrusion on the rights of states and local governments to issue these bonds would appear to be unwarranted until the Administration and the Treasury Department have an opportunity to evaluate the effects of recently enacted laws and regulations.

Appendix C of the Proposals indicates that in 1990 the impact upon federal revenues of adoption of all parts of Chapter 11 relating to all kinds of municipal tax-exempt financing will be a nat benefit to Treasury of $4.7 billion. Public power financing is not computed in determining this net benefit figure, but if included, would be only a small part of it and would be de minimis when compared to other portions of the proposed reforms - for example, repeal of the deductions for state and local taxes will mean an increase of $40 billion for Treasury. The revenue impact projected in Appendix C by the United States Treasury is based upon the loss of exemption on the $57.1 billion (1983) of non-governmental tax exempt bonds. Power issues (by joint agencies of about $5 billion and cities and towns of about $5 billion) are not included in this figure but are included in "other tax exempt bonds" of $36.2 billion for which Treasury assumes no additional tax revenues. Consequently, any gain of revenues to Treasury resulting from the loss of tax exemption on public power issues is a bonus over and above what the Proposals contemplate. Thus to the extent that the Proposals are revenue neutral, any further taxation of interest on municipal bonds than that projected by Treasury, would result in excess tax revenue.

Moreover, any added revenue to Treasury from the loss of tax exemption on public power would be de minimis. In 1983, only about $10 billion in public power issues were marketed. Assuming that all these issues have maximum 25% sellbacks, that all bond holders owning such bonds were in the 50% tax bracket, and finally that all bonds uniformally bore 10% interest rates, the maximum revenue loss by Treasury would only be $125 million. Compared to the potential $40 billion gain resulting from removing state and local tax deductibility, the tax exempt public power revenue impact is de minimis at best.

However, IMPA must point out that the disallowance of a deduction for local taxes will undoubtedly result in local efforts to further reduce local taxes or at least inhibit increases. Local government should not be penalized in this reform package with legislation that both inhibits providing governmental services thru taxes as well as thru borrowing. If the deductibility of local and state taxes is the price of tax reform, cities and towns should not be further penalized by restricting tax exempt financing.

### (A) Adoption of the 1% Rule and Removal of the 25% Rule

#### (i) The 25% applied to Generation & Transmission

One of the most serious consequences of the Proposals would be the replacement of the 25% rule with the 1% rule. Under this proposed change the tax-free nature of the interest on obligations the proceeds of which were used to purchase electric generating facilities when a part of the output in excess of 1% is sold to an investor-owned utility would be lost.

The acquisition by IMPA of its ownership interest in Gibson Unit No. 5 was made economically attractive because of existing regulations under Section 103 which allowed IMPA to sell up to 25% of the average output of the facility to PSI over the plant's lifetime by selling a large percentage of that output during the early years of the plant's life. IMPA takes back the output in the later years of the plant's life as IMPA's need for the unit grows and as the plant's costs are at or below the cost of alternative power. Thus, because of the ability to make such sales, IMPA's rates to its members can be held low during both the last years of the plant's useful life (because it's costs are then lower than alternative power) and in the early years because of the ability to sell output to PSI.

The present 25% rules recognizes practical needs of the electric industry. It encourages joint ownership of units and thus avoids some of the consequences of excess capacity. Thus joint ownership of electric generating facilities in the current era of high cost construction and excess capacity makes good economic sense.

Realistically, joint ownership is practicable only as long as the municipal agency can sell some of its output to an investor-owned utility. Good utility planning calls for the construction or purchase of capacity in excess of current needs of the municipal utilities. This is true because of economies of scale and the long lead time (8-12 years) needed to develop new electric plant sites. That part of the output of a new facility not immediately needed to provide the load of the utility constructing or owning the plant is sold to another utility as a unit power sale. Thus, as load increases in later years, capacity at older prices is available to provide for that growth as the unit power sale comes to an end. Having the lower cost capacity keeps rates low. Moreover, joint ownership helps mitigate the impact of the costs of excess capacity by spreading those costs over a larger number of ratepayers.

The Proposals would drop the 25% figure to 1% and consequently reverse a long standing public policy favorable to joint ownership of electric generating and transmitting facilties. Thus, IMPA could not sell more than 1% of the output annually, in that part of the unit owned by IMPA, to an investor owned utility and still be able to issue bonds the interest on which is tax-exempt. This drastic change would impair the economics of IMPA's acquisition of an ownership interest in a plant like Gibson Unit No. 5 and either make IMPA's acquisition uneconomical and impracticable or, if the unit were acquired, result in substantially higher rates for electricity to the 250,000 people served in Indiana cities and towns by its members.

(ii) Loss of the 25% Rule Applies to Distribution Facilities

The reduction to 1% from 25% also impacts directly on bond issues which cities and towns might market to help finance construction of distribution facilities, i.e., those facilities used to deliver electricity to the retail customer from the point where IMPA delivers it to the member. Although the Proposals lack definition, several interpretations (none of which IMPA concedes are logical) might be advanced. First, and most illogically, one might argue that in any instance where a member city or town had a customer whose use of the member system exceeded 1%, and that member constructed a distribution system improvement, then in that event, the bonds issued for that construction would not be tax exempt since the customer's non-governmental use of the bond proceeds exceeded 1%. Taken to its most logical extreme, any city with a single customer having more than 1% of the city's load would be disqualified from issuing system wide debt. Illustrative IMPA member cities having such loads are shown on Attachment A. Since the use of these facilities will be available equally to the public pursuant to tariffs filed with the PSCI, the Proposals should have specific language permitting the kind of use with tax exempt financing.

A second possible interpretation would involve an issue more than 1% of which is used to construct a substation which would be an integrated part of the municipality's electric system, but which is directly connected to an industrial customer of the municipality. The question is whether this issue would be taxable or be deemed non-exempt. Logic dictates that the issue be exempt since the customer is taking serviçes under tariff like all other customers in its class. Any other interpretation would needlessly complicate maintenance of an electric system and render all service to all customers more expensive. These examples of possible interpretations of the Proposals, as illogical as they may be, demonstrate the fairness and equitableness of retaining the 25% rule for distribution service by cities and towns.

(iii) Public Interest Preserved with 25% Rule

The proposed loss of benefits for public power are not in the public interest. The acquisition of electric generating and transmitting facilities at the lowest possible cost serves a public purpose in that it keeps rates lower than they would be otherwise. This use of tax-free financing to perform a vital governmental fuction for all of the inhabitants of the 25 member municipalities, 250,000 beneficiaries, is unlike using tax-exempt funds to provide private economic benefits to single industrial or commercial entities within a member city or town. The providing of economically priced utility services is as important to a city and town as is the providing of good streets and public buildings.[5] Keeping electricity rates lower has been a

[5] The courts in Indiana have held the operation of an electric plant by a municipality to be a governmental purpose and an exercise of the police power. Chadwick v. City of Crawfordsville (1940), 24 N.E. 2d 937, 216 Ind. 399. Furnishing electricity is an inherent right of the city which it may undertake without express statutory authority. In City of Crawfordsville v. Braden (1891), 28 N.E. 849, 130 Ind. 149, the Indiana Supreme Court said: "There can be little or no doubt that the power to light the streets and public places of a city is one of its implied and inherent powers, as being necessary to properly protect the lives and property of its inhabitants, and as a check on immorality." (pp 156-157)

major political goal in many states, including Indiana, and is an issue of keen public concern in that state. A federal policy which denies the ability of cities and towns to provide reasonably priced electric service (which will be the effect of the tax reforms discussed in this paper) is directly contrary to what many states, including Indina, have perceived as being in their best interest and frustrates the ability of the states' political subdivisions to provide a critical governmental function.

The Proposals contend too many bond issues of questionable public purpose under Section 103 which exempt interest from taxation have been issued. Bond issues for governmental purposes such as those which make possible electricity for the nation's cities and towns should not be penalized merely to eliminate egregious abuse of tax-free bond issuance for non-governmental purposes by others. Use of the 25% rule in the acquisition of electric generating and transmission facilities should not destroy the public or governmental purpose of any part of an issue.

The Proposals suggest that certain allocation rules might be adopted that would permit tax-exempt financing for a proportionate share of the cost of afacility used in part for public and in part for private purposes. No significant elaboration of these allocation rules is given. Consequently, it is difficult to determine exactly how these rules would impact financing for a project such as Gibson Unit #5. However, based on a variety of assumptions (which may or may not reflect the intent of the Proposals), a sale of debt, part of which would be taxable, and the balance of which would be non-taxable, results in substantial additional interest costs over the life of the bonds which must be borne by retail ratepayers of the cities and towns through higher rates. Similarily allocation rules would be administratively burdensome and expensive to implement at the city and town level and result, most likely, only in higher utility rates without any compensating public benefits. Thus such allocation rules appear less in the public interest than the maintenance of the 25% rule. When the use of the 25% rule helps preserve lower utility rates, the entire bond issue should remain tax-exempt.

### (iv) One Solution

At the time of the enactment of the Tax Reform Act of 1984 ("Reform Act"), Congress recognized the need to treat certain public power projects differently for purposes of the applicability of the 25% rule. Thus, in Section 629 of the Reform Act, Congress redefined "exempt person" so as to allow sales by a public power authority to other utilities which would result in exceeding the 25% rule but only so long as such other utilities did not receive a mark-up in the resale price charged by them to retail ratepayers for the power purchased from the public power authority. In this way Congress was able to rationalize that the purchasing public utility would not receive direct benefits from the issuance by the power authority of Section 103 revenue bonds. Such an approach for all public power generation and transmission issues might be a realistic compromise between the Proposals and maintenance of the status quo. It could be structured so as to allow a continuation of the 25% sell-back rule for generation and transmission but only as long as the cost of the sold-back power and energy was passed directly through to the power buyer's retail ratepayers without mark-up.

### (B) Long-Term Management

Certain comments in the Proposals seem to suggest that any contract entered into by a municipal or joint agency utility with an investor-owned utility for a term in excess of a year which provides for the operation and management of jointly owned utility plant by the investor-owned utility will disqualify the investment made to purchase that plant with tax exempt financing. IMPA believes it would be extremely disadvantaged by any such provisions.

The suggestion seems illogical since the length of a contract would have no bearing on any benefit conferred upon the investor-owned utility or the governmental purpose of the facility. In many instances, in fact, the investor-owned utility receives no additional profit on operating and managing the jointly owned facility but merely collects from the joint owners their pro rate share of the actual costs of operation and maintenance.

Moreover, as a practical matter the investor-owned utility would refuse to make a sale of an ownership interest in a generating unit or a transmission grid if it meant giving up the right to operate and manage that unit. This attitude is natural since in most cases the investor-owned utility owns most of the unit.

Finally, it should be emphasized that municipalities and joint agencies seldom have the expertise to operate and maintain the generating units in which they buy an interest. For the joint agency to operate and maintain the generating unit it would have to develop costly in-house expertise, thus increasing rates to its members. The Proposals, if accepted, would frustrate the ability of municipalities and joint agencies from operating in an efficient manner and lead to the costly requirement of duplicating manpower and knowledge already available and in place by the investor-owned utility.

If Congress were to enact this concept, it could effectively eliminate further projects involving joint ownership of electric facilities. This destruction of a proven financial device would be without revenue impact and would reverse otherwise clear federal policy which through the tax laws has encouraged joint ownership and use.[6]

### (C) Other Problems

#### (i) Arbitrage

The Proposals which would provide for more restrictive arbitrage rules would really constitute the imposition of federal income tax upon revenues of political subdivisions of states which have been non-taxable pursuant to Section 115 of the Internal Revenue Code. Arbitrage receipts (while not nearly as economically significant to the rates charged the ultimate retail

[6] In legislation enacted in 1985, the Indiana General Assembly adopted a state policy favoring joint ownership and use as a means to avoid excess capacity and higher electric rates.

consumer of electricity as the economic impact of the 25% rule) still contribute substantially to the Agency's ability to keep the cost to its members low and its total borrowing below what would be required without the ability to arbitrage. Therefore the ability of the members to benefit from arbitrage helps to keep retail rates low.

While the Proposals would be thought to be financially neutral on the bond issuer's profits and losses from arbitrage, in fact this is not true. First, the bond issuer will be denied unlimited arbitrage on investments held in a reasonably required reserve or replacement fund. Second, in computing arbitrage profits, the Proposals will always generate a loss in any arbitrage situation. This one-way street is created by virtue of the Proposal's method of computing and comparing yields. Yields under the Proposals will be determined without regard to various underwriting costs. Issuing yields will be arbitrarily reduced by these costs and when compared to arbitrage yields will lead to paper profits. Both these paper profits and arbitrage profits must then be rebated to the United States government as taxes on state and local activities.

These rebate portions of the Proposals impose an unwieldy and unnecessarily complex administrative burden upon local governments with respect to the cumbersome arbitrage restrictions which are unneeded because current rules, given adequate time to be fully implemented, will prevent any abuses the Treasury Department feels may exist. These rebate proposals impose an unnecessary layer of paperwork upon local governments without achieving a corresponding benefit.

Under current law, arbitrage earnings may be retained by an issuer, but are taken into account when determining the size of a bond issue by netting the amount needed to fund the project against the expected earnings. Under the Proposals, this net funding concept would be lost and, accordingly, issuers would be forced to issue more bonds than are actually necessary for the project, pay higher interest costs because they would be paying interest on the excess amount of bonds issued, and pay those earnings that could have been used to fund the project to the federal government.

(ii) Advance Refunding

The Proposal with regard to advance refunding would effectively prohibit advance refundings. While IMPA has not yet had the need to advance refund, it could economically benefit from such a procedure if debt cost continues to decline so as to make refunding of IMPA's 10 1/4% debt cost for its financing of Gibson Unit #5 attractive. Some of IMPA's members have issued advanced refunding forms and have enjoyed substantial savings in inherent costs which were passed on to retail ratepayers through lower retail electric rates. The bottom line of any such refinancing, of course, is this reduction in debt service and as a result a reduction in rates to the retail ratepayers.

(iii) Reporting Requirements

The imposition of the 1982 Tax Equity and Fiscal Responsibility Act reporting requirements on issuers of public power bonds would impose needlessly complicated, burdensome, and expensive obligations upon those issuers. All issuers would have to train staff or engage professionals to handle these reporting requirements at additional cost to electric ratepayers.

(D) Transition

As it did when it adopted legislation concerning the issuance of industrial development bonds in 1968, and as it has continued to do in many cases thereafter, Congress should phase in the impact of any of the Proposals it adopts. Thus, projects which have been formally approved by the governing bodies of the municipalities or political subdivisions prior to the effective date of whatever legislation is finally adopted should be allowed to proceed with the issuance of bonds the interest on which is tax-exempt. These issues should be allowed to benefit from the 25% rule, to the extent it may be modified by adoptions of part of the Proposals. Thus, only projects conceived and developed after the new tax rules become effective will suffer the penalty of having the interest thereon taxable.

## (E) Conclusion

The providing of electric service is an inherent governmental power and right. This right and other rights of cities and towns and joint agencies have been narrowed and eroded by a series of changes to the law regulating the issuance of tax exempt municipal debt.[7] These Proposals will more narrowly define cities' and joint agencies' rights.

Consequently, IMPA believes that the public interest can best be served, and municipal ratepayers' rates kept low by a continuation of the ability of joint agencies and municipalities to issue tax exempt debt for public power projects. Because of economic and engineering constraints in the way power projects are built, the joint agency can effectively perform its governmental function of providing electricity to its members only so long as it can continue to utilize the existing 25% rule and contract for the investor owned utilities to manage jointly owned power plants and joint transmission. IMPA submits these key ingredients to public power financing, as well as the others discussed in this paper, are required to produce a fair and equitable tax package for tax-exempt public power municipal financing.

[7] The Reform Act and the enactment of private bond limitations during the 1980's.

Respectfully Submitted

Indiana Municipal Power Agency

September 24, 1985

The CHAIRMAN. Let me ask you and Mr. Patterson on the issue of arbitrage: It seems unfair to us that you get to issue tax-free bonds at a slightly lower rate, which does cost us some money—you can argue whether it costs us a lot or a little, but we think it costs us some—and then you get to invest the proceeds for a short period of time in a higher rate, a bond, or common stocks, or wherever you are allowed to invest in your local governments, and that just doesn't seem fair to us, that we subsidize the bond, and then you get extra profits for the short duration when you were not ready to invest it in the particular purpose for which the bond was issued.

Why is it fair to leave it as it is?

Mr. TILTON. Well, I would say that as an issuer we are not at all excited about dealing with the investment banking firms, and we would rather issue bonds as infrequently as possible.

What that results in is a situation where, as an issuer, we try to plan the use of bond proceeds to match a construction period for a project. We would rather issue bonds, say, once a year or once every 2 or 3 years, keep those proceeds, invest it, and then call on those proceeds as the construction costs of the project come in.

Now, if we are able to invest those proceeds in high yielding investments, it means that as we pay out those construction costs, we are paying the construction costs partially with tax-exempt bond proceeds and partially with arbitrage earnings. So, we end up having to issue fewer tax-exempt bonds in order to produce the final total construction dollars required for the project.

For that reason, I think that within the framework of the current arbitrage regulations we have a reasonable and workable situation.

The CHAIRMAN. Mr. Patterson.

Mr. PATTERSON. Mr. Chairman, I think it probably goes to the purpose of issuing the bonds. In our State, we issue the bonds for a worthwhile and desirable public project, and we don't issue the bonds to gain arbitrage. But in the course of issuing bonds, obviously you can't issue bonds on the day that you need to pay for the project.

So, the business of arbitrage is a cash-management tool which obviously anybody worth his salt is going to use. So, I don't see any problem with the current rules that exist as they relate to arbitrage.

I do not think the requirement or the suggestion by the Treasury that you issue the bonds on the day that you pay for the project is absolutely unfeasible; it simply will not work.

The CHAIRMAN. Mr. Solem, a question for you. And Senator Durenberger expressed his regrets; he went to chair an Intelligence Committee meeting and would like to have been here.

Housing is clearly a public purpose. The Federal Government subsidizes it with the mortgage interest deduction. And it doesn't matter if your house is $500,000 or $50,000. It doesn't matter at the moment under the present law if you do it for a second house, third house, fourth house, or fifth house, all at the same time.

If we think that housing is a valid public purpose, why shouldn't we leave it for State-to-State-to-State, to determine from their standpoint what the limits on the use of housing bonds ought to be in that State? Why put any Federal limits on it, either as to the size of the cap or as to the certain amounts must go for low income, and whatnot?

Mr. SOLEM. Mr. Chairman, I think all of us in State agencies would support the first part of that last statement you made, in terms of letting States establish standards and limits. That is probably not realistic in the current set of conditions, in terms of the deficit and the problems of the Federal Government; so therefore, we recognize the need for reasonable Federal standards that have some ability of State and local issuers to adjust to particular conditions within their States. Minnesota is different than Maine; Maine is different than Texas.

The CHAIRMAN. Yours is a more pragmatic answer, rather than a philosophic answer.

Mr. SOLEM. Right.

The CHAIRMAN. In a perfect world, do you think that Minnesota ought to say, "We think housing is great" and issue whatever they want? But Maine wants to say, "We don't think housing is quite that great; we would rather issue it for some other purpose," and that is up to Maine?

Mr. SOLEM. Exactly. That is exactly the argument I would make, but that isn't the real world. In the real world we have to accept the pragmatic facts of life, and the facts of life are that with reasonable standards we can develop programs that fit the particular needs in a given State. And that is the spirit and that is the thrust of the recommendations that the Council of State Housing Agencies and the local association make to this committee.

The CHAIRMAN. Senator Mitchell.

Senator MITCHELL. Thank you, Mr. Chairman. I would like to ask Ms. Boland a question.

Why don't you agree that the private-purpose definition which excludes housing bonds is a correct categorization. I heard some comment on that today.

Ms. BOLAND. Senator, my understanding of how that definition was arrived at is limited. It strikes me as being a very technical definition, particularly with respect to the beneficiaries of the program and the historical nature.

Housing bonds have been used for some time. They are issued by public entities. They are issued in the context of a public program. And they serve a very important public need. They are the remaining tool available for States to provide affordable housing for low- and moderate-income families.

The States have demonstrated their appropriate ability to target these programs to meet that public purpose. The States have used the programs for a broader range, beyond the social benefits of the program, to provide community development and other recognized State needs.

So, I think the term "private purpose" is not reflective of the broad scope of the program and the beneficiaries that are served by it.

Senator MITCHELL. Can any changes be made in housing programs so that they would be more public-purpose oriented?

Ms. BOLAND. I think that the Congress over the recent years has adopted a number of restrictions that have targeted the programs more carefully. The States of their own accord have adopted restrictions, as Maine has, including income limits, in some cases lower purchase price limits, set-asides of portions of the bond proceeds for very low or lower income families, and the Council of State Housing Agency proposals that we have presented to you today is a further example of targeting of the program to better use a scarce resource to serve those needs.

Senator MITCHELL. It is my understanding that in the construction of low-income rental housing, the bonds are only a part of an overall tax incentive package. Are there other incentives that are important to your agency in its operations?

Ms. BOLAND. Our view of the nature of the construction programs is that it takes both debt financing incentives as well as equity incentives to make those programs work. This is particularly true in Maine, but I think it has relevance across the country, particularly when you are serving lower income families, that one cannot attain in the rental structure alone a sufficient return on equity to entice investors to construct such housing.

In Maine our rental markets are relatively limited, to the point where the State is, in fact, subsidizing the early rents on those units in order to encourage construction in markets outside of the more urban areas.

So, I think simply looking at an economic proposal for development of rental housing does not provide sufficient return to construct rental housing for low- and moderate-income families. One must have the equity incentives that are built into the code.

Senator MITCHELL. In practice, does your agency and other State and local issuers regularly place more restrictions on their programs than does the Federal Government.?

Ms. BOLAND. Many of the State agencies, as I mentioned, are providing additional limits to their program. Our agency has a longstanding policy to set income limits for those who can be served by our single-family mortgage program. We set rental limits on our rental loan program, constructed with tax-exempt bonds; and I think those kinds of limitations are increasingly common at State agency levels.

Senator MITCHELL. Do the issuing authorities generally have sufficient monitoring capability to ensure compliance with restrictions.?

Ms. BOLAND. Yes; I believe that they do, particularly with respect to the State agencies. They are established institutions, many of which, such as ours, have been around for 10 or 15 years, have significant portfolios which they have staffed to monitor on an ongoing basis, so that they can assure compliance not only with the Federal requirements, with respect to the bond issue, but with all of the financial requirements necessary to assure that those bonds will be repaid.

Senator MITCHELL. Thank you very much, Ms. Boland.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Rutherford, let me ask you about the Mortgage Certificate Program. Oregon passed its program in June, have you issued any mortgage credit certificates yet?

Mr. RUTHERFORD. Well, we have been unable to implement the plan, although it did pass the legislature rather handily last year. But we have been unable to implement it, primarily because of the pending legislation on tax reform. So we would like very much to get on with it.

The CHAIRMAN. So, at the moment you are all ready to go.

Mr. RUTHERFORD. We are ready to go. It is a pilot program.

The CHAIRMAN. And if this bill drags on until the middle of next year, you won't go until it's done?

Mr. RUTHERFORD. That is correct.

The CHAIRMAN. And this program, as I recall, runs out in 1987.

Mr. RUTHERFORD. That is correct.

The CHAIRMAN. That gives you a very small window.

Mr. RUTHERFORD. That is why we need relief.

The CHAIRMAN. Let us go back to industrial development bonds. All of you, I guess, have had some experience either in issuing IDB's or know about them. Do any businesses locate in a State because of industrial development bonds?

Bill.

Mr. PATTERSON. Well, I think the answer to that is that industrial development bonds are only one of a number of considerations that a company takes into account when determining to locate. And all things being equal, and all states having the opportunity to issue those bonds, I suppose that then it just becomes who is the highest bidder on them. I think that they probably look at local tax, electricity rates, job markets, and things like that, as well. I am sure they do.

The CHAIRMAN. From the Federal Government's standpoint, what do we gain? If you start with the presumption that nobody is going to build a factory unless they can sell the product, and they can go to Oregon, they can go to Wisconsin, or Maine, or Minnesota, and say, "What is your corporate tax structure; what is your individual tax structure; what kind of rebates do you give for property taxes, and what not," but the bottom line is that they are not going to build it if they can't sell the product, or at least I assume they won't. To us it often seems like the use of industrial bonds are just one city outbidding another or one State outbidding another, or a business locating in Portland, OR, rather than in Pittsburgh, or locating in Bend, OR, rather than in Denver. We know the ones we get; we often don't know the ones we lose.

Are any additional jobs created that would not otherwise be created someplace, solely because of industrial revenue bonds?

Mr. PATTERSON. I think the argument would run something like this, Senator, that the plant would not pencil out without the lower income rate, and therefore would not be built anywhere, whether it is in Oregon or Colorado, if the bonds were not there. I think that is the way the argument goes.

The CHAIRMAN. But if every State can issue them, and they are all subject to the same rules, how is the Federal Government a net gainer in this?

Mr. PATTERSON. Well, again, I think the argument would run that the Federal Government doesn't care whether it is built in Colorado or Oregon or whever; but what they do care is that there are some additional jobs created, because from that they would derive tax benefits and economic activity. I believe that would be the rationale.

The CHAIRMAN. I understand that, but if all States can offer the same inducement, then how does the Federal Government come off with any net jobs created by the industrial development bond program?

Mr. PATTERSON. Well, you would have to go back to square one and make the assumption that the plant would not be built in the first place, anywhere, because it didn't have this access to low-priced capital. That is, the plant simply wouldn't pencil out, except for the fact that the interest rates would be lower.

The CHAIRMAN. So then it comes back to the issue that indeed job creation is a public purpose?

Mr. PATTERSON. That is the judgment that would need to be made.

There is one other aspect of industrial development bonds that I think should be considered, and that is such things as convention facilities, which really are public kinds of activities. You know, Portland is very interested right now in building a convention center. If industrial development bonds are not going to be available for this purpose, something should be available for that purpose, because that is clearly a public facility.

The CHAIRMAN. I don't think I have any more questions. George?

Senator MITCHELL. No questions, Mr. Chairman.

The CHAIRMAN. Thank you very much for being with us today.

Now we will conclude with a panel of Don Durig, National Resource Recovery Association, and director, solid waste, Metro Service District, Portland, OR; Lloyd D. Anderson, executive director of the Port of Portland; Patricia Hayes, the president of St. Edwards University, on behalf of the National Association of Independent Colleges and Universities; Merlin Duval, president of American Healthcare; and Jack Owen, executive vice president of the American Hospital Association.

Mr. Durig?

## STATEMENT BY DAN DURIG, TRUSTEE, NATIONAL RESOURCE RECOVERY ASSOCIATION; AND DIRECTOR, SOLID WASTE, METROPOLITAN SERVICE DISTRICT, PORTLAND, OR

Mr. DURIG. Thank you, Mr. Chairman.

At the Metropolitan Service District, a directly elected regional government which serves 1 million people in the Greater Portland area, we manage the disposal of some 750,000 tons of material each year. Our solid waste management problem in Portland is very similar to that encountered by other public agencies throughout the country.

The traditional method of solid waste management in this country, landfilling, is now considered to be the least desirable way to handle this every-increasing mountain of waste. Throughout the United States, landfills are reaching capacity or competing with very sensitive environmental areas such as major aquifers which provide irreplaceable drinking water. Virtually every regulatory agency, from the Federal EPA to State environmental agencies now suggest that we use landfilling only as the last step in solid waste management.

The positive side of this challenge is that there is a better way to deal with solid waste; it is resource recovery. This involves the recovery of material or energy through the application of modern technology. Resource recovery has come into its own during the past 15 years in the United States, and is now the preferred method for dealing with the Nation's solid waste problem.

A very important component in the development of these facilities has been the tax incentives that are available through tax-exempt financing.

My primary point in this testimony is to urge the preservation of this tax incentive, in order to assure the continued development of these desperately needed public facilities.

The concept of what qualifies for public-purpose activities is extremely relevant when wo talk about the management of the Nation's solid waste. Historically, the public sector has carried the responsibility to ensure that the public health is preserved through the proper management of solid waste. In many ways, it has been the outstanding example of bringing together public responsibility and private-sector cooperation to ensure that the public interest is served.

Resource recovery facilities are complex capital intensive projects. They have lent themselves very well to full-service contracts whereby a private vendor, typically through a competitive process, is retained by a public agency to design, construct, and operate these projects.

These full-service contracts are not without risk; indeed, the ability to produce the contracted amount of energy, to handle the agreed upon amounts of solid waste and to meet ever-changing environmental regulations are typically borne by the private company through a contractural arrangement with a public entity. I believe it is very important to recognize who the beneficiary is in this arrangement.

While the private sector certainly plays a key role, it is the general public, all of us, that benefit from environmentally sound, well managed solid waste facilities. Every organization and individual in the country produces solid waste in one form or another. They benefit from these projects directly, and the environment in which they live is well served by these projects.

This is not a narrow regional or special-interest issue; it is a topic which affects every American.

We would urge a definition of public purpose which recognizes the historical responsibility for public agencies to oversee solid waste management and one that appreciates the important involvement of the private sector in this public service.

The development of these resource recovery projects through provisions now available with tax-exempt financing are critical to this effort. It is ironic that after many years of education, at a time when public understanding of these projects has now become well established, that when the technology of these projects has been accepted in this country, and when both Federal and State agencies are strongly encouraging movement away from landfilling toward these projects, we could lose the critical support of tax incentives needed for the financing of these projects.

Finally, when one considers that the use of tax-exempt financing for these proposals would result in an average annual revenue loss of less than $50 million over the next 5 years, and we contrast that with the billions now being spent through Superfund dollars in order to correct past landfill practices, the short-term financial loss is indeed modest.

I do appreciate the opportunity to testify. Thank you very much.

The CHAIRMAN. Good job.

Lloyd Anderson, one of the experienced public service citizens of this country, served on the Portland City Council for a number of years, and I think would have been mayor had he chosen to stay on the council and run. But he, instead, went off to the Port of Portland and became executive director and left elected public life for nonelected public life. I am not sure which is tougher. And he has been before this committee and almost all the other committees of this Congress at one time or another, either on behalf of the Port of Portland or representing various national associations to which he has belonged and led.

Lloyd.

[Mr. Durig's written testimony follows:]

NRRA

# National Resource Recovery Association

TESTIMONY DELIVERED BEFORE

THE SENATE FINANCE COMMITTEE

SEPTEMBER 24, 1985

by

Dan Durig
Director, Solid Waste
The Metropolitan Service District
Portland, Oregon

on behalf of

The National Resource Recovery Association

UNITED STATES CONFERENCE OF MAYORS
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## SUMMARY

The Administration's tax reform proposal calls for the elimination of private purpose IDB financing for municipal resource recovery solid waste disposal projects. Resource recovery is the only major viable alternative to landfilling for the disposal of municipal solid waste. By developing resource recovery projects, public entities can avoid the long term negative environmental affects of landfills. Federal environmental law encourages movement to the development of resource recovery projects.

However, resource recovery projects are technically complex, and capital intensive. Many cities have traditionally resorted to a full service arrangement with the private sector to build, own and operate such facilities. The public entity in turn is able to negotiate strong performance guarantees—through long term service contract agreements which shift technical risk to the private sector.

We believe solid waste disposal projects that serve the general public should qualify for public purpose, public use tax-exempt financing. Solid waste is generated by the public at large and its environmentally safe disposal clearly is a matter of public interest.

The revenue loss to the federal treasury would be minimal. In a recent study using Treasury methodology, de Seve Economics concludes that preserving tax exempt financing, the ITC and CCRS class 4 property for resource recovery equipment would result in an average annual revenue loss of less than $100 million over the next five years.

Good morning Mr. Chairman, I am Dan Durig, a member of the Executive Committee of the National Resource Recovery Association (NRRA) and Director of Solid Waste of the Metropolitan Service District, Portland, Oregon. The NRRA is an affiliate organization of the U. S. Conference of Mayors and was formed three years ago to assist public entities in developing alternatives for disposal of municipal solid waste. The Metropolitan Service District, a regional government, is responsible for solid waste disposal in the Greater Portland Metropolitan area.

I want to make two major points in this testimony:

1. The development of public service waste-to-energy projects in this country requires tax incentives to replace undesirable landfills and to avoid the need to find land for more landfills. Without these incentives, waste-to-energy is economically unattainable -- at best marginal -- in most areas of the country because the loss of present tax incentives raises the cost of disposal at these facilities at least 50 percent.

2. Congress may rightly decide to confine tax-exempt financing to truly "public purpose" activities. But "public purpose" need not preclude private involvement that is critical to making resource recovery available to the public. Just last year Congress recognized the special public-private partnership in this

area and prescribed the terms under which it would continue to have access to major tax incentives. That same recognition should be carried on in the current tax proposals.

Congress has made clear in the federal environmental laws that it is national policy to develop resource recovery facilities. Existing federal environmental regulations i.e., the Resource Conservation Recovery Act, are designed to encourage resource recovery and to discourage landfilling. This is because resource recovery (the combustion of refuse and generation of steam and/or electricity in precisely designed and operated facilities) is the most environmentally acceptable and resource efficient method for disposal of municipal solid waste.

In fact, in many cities and localities landfills are posing an immediate threat to the safety of drinking water supplies and the environment in general. Other localities are literally running out of places to landfill municipal refuse. One of the most volatile, divisive issues many communities face today is where to locate a new landfill.

Although the primary purpose for developing resource recovery projects is the disposal of municipal waste and the relief of this environmental dilemma, resource recovery has the potential for turning a national liability -- municipal solid waste -- into a national asset. Each ton of refuse processed at a resource recovery facility generates the equivalent amount of energy of a barrel of crude oil. With resource recovery, municipal solid waste can be used as a constant, replenishable domestic supply of fuel rather than simply being an ever increasing consumer of valuable land area: land that could otherwise be put to economically productive use.

Waste-to-energy solid waste disposal facilities are the only alternative to landfills. These facilities are capital-intensive, complex technological processing plants which require special expertise to operate efficiently and safely. Even more importantly, local government cannot politically or financially absorb the risk inherent in these projects. We need the private sector to shoulder this burden. Compensating the private sector in part through the tax advantages of tax-exempt bonds brings the cost of these projects within each of many communities which would otherwise have no option but to open another landfill. This represents an appropriate level of federal support. It in no way diminishes the reality that proper and adequate waste disposal continues to be the traditional responsibility of local governments in their role as guardians of public health and safety.

Therefore, most cities traditionally have entered into full-service contractual arrangements for design, construction and long-term operation with system vendors (i.e., private developers/ operators). Under these arrangements the system vendor assumes substantial risk for non-performance of [illegible] facility. This results in assurance to the municipality that the environmentally safe disposal services needed will be delivered on a continuing reliable basis; and, the price it will pay for such service can be anticipated. Localities cannot afford facilities, either practically or economically, that do not operate properly on a long-term basis.

Vendors rely on available tax benefits, namely the investment tax credit (ITC) and accelerated depreciation, to provide services that are affordable to local government and its constituents and that offset the many costly risks of non-performance. These risks can range from not meeting an agreed to construction timetable during which, of course, interest payments must be paid; not being able to generate agreed to amounts of energy, the revenues from the sale of which are used to reduce facility operating costs; not being able to operate within stringent environmental regulations, which can cause the facility to be shut down; or not being able to process agreed to volumes of waste.

The Administration's tax reform proposals would deal a serious blow to the development of waste-to-energy facilities.

Effective January 1, 1986, the Administration proposes to:

-- prohibit tax-exempt financing of privately-owned solid waste disposal facilities even if they serve the entire community by providing the public with waste disposal service;

-- prohibit tax-exempt financing of publicly owned projects that sell more than one percent of the energy produced to a non-governmental purchaser;

-- prohibit tax-exempt financing for publicly owned projects that have longer than one year operating contracts with private companies; and

-- significantly diminish the value of tax benefits for privately owned but community-wide plants and equipment placed in service after that date.

The impacts of these proposals on resource recovery development are severe. Preliminary analyses indicate that the cost of waste disposal at such projects could rise 50 percent to 65 percent over what they are projected to be under current tax law.

Communities which finance projects after January 1, 1986 will be faced with difficult choices:

-- significantly higher disposal costs associated with taxable borrowings:

-- Increased project risk because of the loss of private participation, if tax-exempt financing is to be retained;

-- Increased costs from payments to private industry due to the limits on operating contract length coupled with a municipality's need for performance guarantees; or

-- a combination of these effects.

In a medium sized locality planning a resource recovery facility with 750 to 1300 tons-per-day capacity the proposed tax-law changes could increase average annual budgetary outlays for waste disposal by anywhere from $3 million to $20 million depending upon reasonably expected taxable interest rates. In larger municipalities requiring plants in the 2000 ton-per-day range, average annual budgetary expenditures could increase by $17 million to $28 million at any single plant.

These budgetary pressures will force some localities into continuing environmentally unacceptable landfill practices. Lost in the process will be the awareness that landfilling, in most circumstances, only postpones finding a more permanent solid waste disposal solution and that the postponement only increases the ultimate disposal cost and risks of environmental damage.

Tax benefits for resource recovery facilities do not cater to a special interest group. All individuals generate garbage, and everyone benefits from its environmentally appropriate disposal. Everyone bears the cost of waste disposal. Moreover, localities only resort to these new systems when faced with loss of landfill space or related pollution problems.

From my vantage point as Executive Member of the National Resource Recovery Association, I can assure you tax-benefits do not create an artificial incentive to initiate resource recovery. These projects are just too costly and complicated for any local elected official to undertake for any reason other than pure necessity. Also, these projects have long operational lives, and once constructed are not likely to be replaced for decades.

We believe that the present combination of tax-exempt financing, depreciation, and the investment tax credit, as limited quite severely by Congress last year, provides an appropriate environment for development of these critical public-purpose projects. It must be recognized that there are no significant direct federal grant programs to assist state and local government resource recovery efforts as there have been for waste water treatment plants. And, there is no prospect for such programs in the immediate future.

In an attempt to define "public purpose" projects the Administration's proposal mistakenly equates public ownership and use with the provision of basic public services. It does not take into consideration that resource recovery is one of the notable examples of the private and public sectors joining together to solve a local government problem at less cost and risk to a locality than the traditional means employed by public entities.

Last year we were pleased to work with the Committee in developing specific service contract rules later enacted by Congress that enabled cities to continue to realize the tax benefits of such contracts as long as certain risks are assumed by the private sector. These rules define under what circumstances a private entity's relationship with the public sector can be considered a service contract (and therefore qualify for tax ownership). Essentially, these rules also require that the risks, burdens and benefits remain in the private sector in order to entitle an equity investor to tax ownership.

The service contract rules carefully define the circumstances under which the "public purpose" is sufficient to allow these tax benefits to be available and the private assumption of risk is sufficient to meet the traditional standards for access to the ITC and accelerated depreciation. These rules carry out both Congress' interest in reducing tax subsidies for the private sector and the public's interest in maintaining the financial viability of environmentally sound and reliable waste disposal facilities.

These rules demonstrate that Congress has already recognized the public/private partnership in resource recovery and the terms under which tax benefits should be available. A new, far more restrictive definition of what constitutes a proper use of tax-exempt bonds is not required. Instead, the service contract criteria or similar rules can be applied to determine under what circumstances a project is "public purpose" and may be financed with tax-exempt bonds.

Mr. Chairman, cities everywhere are facing the problem of ensuring adequate and environmentally safe waste disposal. On the one hand there are intense pressures to close or replace existing landfills. And existing federal law and many states' laws strongly urges the maximum development of resource recovery. Yet, the President has proposed tax measures which will make resource recovery too costly to implement in most communities. There must be some reconciliation of these goals.

A recent study performed by deSeve Economics Associates, Inc. using accepted Treasury revenue estimate models, concludes that the revenue effect on the U.S. Treasury of disallowing tax-exempt financing, the ITC and CCRS class 4 property for resource recovery facilities would be the following.

| Years | (Millions)<br>Tax Exempt Financing | ITC | CCRS Class 4 |
|---|---|---|---|
| 1986 | -16 | -30 | -2 |
| 1987 | -41 | -23 | -4 |
| 1988 | -53 | -52 | -6 |
| 1989 | -59 | - 5 | -7 |
| 1990 | -65 | - 8 | -7 |

Mr. Chairman, as you can see, protection of solid waste disposal projects would not result in a significant loss to the federal treasury.

Thank you for this opportunity to testify.

Dan Durig
NRRA

Source: The Tax Treatment of Investment in Resource Recovery Facilities Under Federal Tax Reform. deSeve Economics Associates, Inc.

## STATEMENT BY LLOYD D. ANDERSON, EXECUTIVE DIRECTOR, PORT OF PORTLAND, PORTLAND, OR, ON BEHALF OF THE COMMITTEE FOR FINANCING PUBLIC TRANSPORTATION FACILITIES

Mr. ANDERSON. Thank you very much, Senator.

You have a detailed presentation by a group that represents the Committee for Financing Public Transportation Facilities, which represents the aviation, mass transportation, and marine operators in the United States. These groups have filed this statement as a joint statement of those organizations.

I think, clearly, we are opposed to the 1-percent limitation that has been recommended in the President's proposal. In examining this proposal with all of the ports in the United States, every marine facility proposed in the last 10 years, and probably every marine facility that has revenue bonds or general obligation bonds behind it, would be eliminated by the proposal.

Conceptually, the approach of a 1-percent limitation as it relates to aviation or marine facilities is not, in our judgment, the proper way to apply any kind of limitation.

It is true, for example, on marine cargo, when you bring, say a ship in that has 3,000 containers on it, there may be 3,000 trucks bringing those containers up to the terminal, and then it is loaded on 1 ship, and that 1 ship then represents generally more than 1 percent of the totals, or that company does, that is coming into the harbor. So, a limitation like that which exempts in this case the highway transportation coming up, but is applicable to the marine side, does not seem to make sense. And that is also true with reference to aviation and mass transit.

So, our view is that, if in fact the aim of the administration and certainly the ports of this country is to expand public facilities, there is a need to do it by more investment in infrastructure rather than less. And as far as we can tell, the proposal here will inhibit infrastructure being built.

As far as we can tell now, there will be about $3 billion invested over the course of the next few years, much of it financed by either revenue or general obligation bonds.

We, for example, had a $40 million measure approved by the voters in the last year. That measure, if it was not tax-free municipal, would have added substantially to the cost of the taxpayers by having in fact that additional cost of interest rates dropped onto it.

I think, finally, one of the questions that Treasury raised is abuses. There is no evidence in any marine or aviation or mass transit—mass transit hasn't issued bonds, but on the other two—that there has been any abuses of the use of that in the building of facilities. So we don't see, as a matter of fact, then, that that kind of thing is relevant to the issue at stake here, which is substantial to the marine and airports of the country.

George Doughty, who is the director of aviation for Denver, is also prepared to make a few remarks.

The CHAIRMAN. Mr. Doughty.

[Mr. Anderson's prepared testimony follows:]

Committee For Financing Public Transportation Facilities

Statement

of

Lloyd Anderson
Executive Director, Port of Portland, Oregon

on behalf of the

**COMMITTEE FOR FINANCING PUBLIC TRANSPORTATION FACILITIES**

on

**Adverse Effects of President's Proposal to Eliminate Tax-Exempt Status for Airport, Seaport and Mass Transit Bonds Issued by State and Local Governments**

**Before**

Comprehensive Hearings on Tax Simplification

of the

Committee on Finance

United States Senate

September 24, 1985
Washington, D.C.

## WITNESSES

Mr. Lloyd Anderson
Executive Director, Port of Portland, Oregon

Accompanied by:

Mr. George F. Doughty
Director of Aviation
and
Mr. Thomas P. Briggs
Manager of Revenue,
City and County of Denver, Colorado

## SUMMARY

### CONGRESS SHOULD CONTINUE TAX-EXEMPTION FOR STATE/LOCAL BONDS ISSUED FOR PUBLIC TRANSPORTATION FACILITIES (AIRPORTS, SEAPORTS, MASS TRANSIT) IN ANY TAX REFORM LEGISLATION

Although the Congress last year decided that bonds issued by state and local governments for public transportation facilities were "public purpose," the Treasury II tax reform proposal (May 1985) would apply a "one percent test of non-governmental use" to airport, port and transit bonds.

Public transportation facilities, however, are structurally unable to satisfy such a test because of the way our nation's transportation system operates. Since these public transportation modes have privately-owned common or contract carriers as "more than 1% users" of their capacity, the state and local governmental sponsors of these facilities would be limited under Treasury II to issuing taxable bonds rather than tax-exempt bonds as at present. The results for the issuers and for the travelling public would be extremely severe: either the costs of developing needed transportation infrastructure would be increased substantially (an estimated 20-30% increase in interest costs) or many projects would be seriously delayed or cancelled altogether.

The state and local governments providing the transportation facilities for assembling passengers and cargo for these three modes of common carrier transportation will continue to require an exemption from any generalized rule that Congress might develop for application to bond financing.

Mr. Chairman and Members of the Committee:

The Committee for Financing Public Transportation Facilities, a coalition of state and local governmental issuers of bonds for the development of their publicly-owned airports, seaports and mass transit facilities, is opposed to the President's proposal to establish a new test for tax exemption for municipal bonds because it would substantially impede all three modes of common-carrier or local public transportation.

As you know, the President's May 28 tax simplification program proposes to change existing law so that, if a nongovernmental person (such as an airline, a marine terminal operator, or a private transit operating company) would use "more than one percent" of the transportation facilities proposed to be developed with the proceeds of a municipal bond issue, the interest paid on those securities would be taxable to the bondholder for Federal income tax purposes.

"Taxable" bonds would involve substantially higher interest rates than would tax-exempt securities, which our members have traditionally issued with your approval. Proponents of the legislation have argued the need for change in tax-exempt bonds because of "abuses" -- or because business ought to "pay its own way" or get out of the business -- that if some facilities can't be built without tax-exempt financing, the cargo or the passengers will still be carried, but just, perhaps, not at the port or the place where chey are -- and that facilities financed with tax-exempt bonds may benefit local or regional needs, but there are no national benefits.

Mr. Chairman, the greatest need of our U.S. public transportation system of airports, seaports, and local transit systems is for more capacity and modernization -- seaports, for example, expect to finance over $3 billion worth of projects during the next five years. But we are fearful that the proposed "one percent test" would inevitably mean taxable bonds and higher interest costs that ultimately would translate into less, not more, public transportation capacity. The public transportation element of our nation's infrastructure needs to keep pace with increasing demand, and higher costs for capital resulting from loss of tax exemption would be a serious deterrent.

Mr. Chairman, let me cite a few recent developments at the Port of Portland as examples of projects that would not be possible within the context of the President's proposal.

The Port began construction of a $46 million renovation of one of the Port's older marine terminals. This project is being financed through a general obligation bond. The voters of the tri-county area (which encompasses the port district) approved this project, and the taxpayers will pay the cost of the project. However, under the President's proposal, this measure would not meet the "one percent" rule. In fact, the industry believes there are no public terminals that could meet such a test.

The Port also owns and operates airports. We just began a $30 million expansion of our terminal, to respond to growth of passenger and cargo -- domestic and international. This project will be financed through revenue bonds, paid for by the airlines. This project could not have been financed if the President's tax proposal had been in effect.

-- The Proposed "One Percent Test" Does Not Work For Public Transportation

The President's "one percent test" to calculate whether proposed transportation development has a valid "governmental purpose" simply could not be met by most of our members. This would produce an illogical result, and one caused solely by the way our nation's transportation functions have been divided, in part through Congressional policy, between the public and private sectors.

The proposed "one percent test" has no real-world applicability to financing public transportation facilities other than roads and bridges because, under longstanding public policy, our nation relies in large measure on competing, private enterprise common carriers to provide public transport services from the public landing and docking and distribution facilities provided by local governments for the use of our citizens.

Our local governmental agencies would, under the President's proposal, be largely limited to issuing taxable bonds, because the runways, airport terminal buildings, and wharves and docks which our governments traditionally provide are used more than one percent by the scheduled airlines and by steamship lines and shippers of oceanborne commerce.

In terms of consistency of national objectives, we suggest there should be no difference between state and municipal bonds issued for road and bridge construction and bonds issued for airport, seaport, and local transit facilities. We would urge this Committee to retain full authorization for these transportation modes to continue financing their traditional activities with tax-exempt bonds.

The Committee on Finance and others in the Congress have discussed and debated a number of new port user charges on our transportation industry. Before this Committee adopts any change to the tax-exempt financing of the port industry, we would urge you to also closely examine the cumulative effects these user charges would have on trade and commerce. Don't give us another negative -- another unknown.

As this Committee knows, exports are most sensitive to changes in costs. In my region, this translates to agriculture and forest products. In contrast, high-value imports tend to better absorb changes in costs.

It would be ironic and tragic if the Congress adopted these changes in tax-exempt financing, under the guise of reducing the budget deficit -- that ended up exacerbating the trade deficit by adding costs to U.S. exports, making them less competitive in the world market.

How could our local governments respond to explicit Congressional policy in favor of having transportation services within the United States provided by governmentally-regulated but private common carriers without our making available to those same entities more than one percent of the capacity (or use) of the local facilities from which those carriers operate?

Need our governments, as an unavoidable consequence of existing national transportation policy, have to pay millions of dollars in extra interest costs to finance airport, seaport, and, potentially, mass transit facilities because the President's proposed new test for tax-exemption doesn't work when applied to our nation's part-public and part-private transportation system?

The only other alternative available to our local governments is equally unreasonable. Under the President's proposal, tax-exempt bonds could still be issued if there were no "more than-one-percent non-governmental middlemen" involved with our transportation facilities.

But we don't believe that Congress wants local governments to consider "buying up" and operating major U.S. airlines just so the runways at publicly-owned airports like Chicago's O'Hare and New York's Kennedy and Cedar Rapids' Municipal won't have private-sector middlemen (airlines) precluding local government's ability to have their future financing kept eligible for tax-exempt interest rates.

For seaports, should the tax code be encouraging ports and local governments to become "operating ports" and also get directly into the steamship business?

Illogical as it appears, state or local governmental ownership of airlines would be the only way under the proposed "one percent test" that these governments could continue to finance, at tax-exempt rates, runways that under Federal law have to be open for public use on a non-exclusionary basis but which, as a matter of arithmetic, are used by the scheduled airlines more than one percent of the time.

In conclusion, Mr. Chairman, we hope that Congress will not change its past decisions of 1968, 1972, and 1982, reinforced again just last year, to allow continued tax-exemption for bonds issued by governments providing facilities for use by common carrier transportation companies so long as those facilities are owned, including for tax purposes, by those governmental agencies.

Nothing has surfaced since the tax legislation last year that would now justify a different result. Our transportation facility bonds are not growing like Topsy but actually comprise a declining percentage share of total municipal debt -- $3 billion or 3 percent of the current annual total. Our bonds are not abusive of the tax-exemption option. The revenue loss to Treasury is very modest in comparison to the importance of the tax-exemption option to our members' ability to get their transportation systems expanded and modernized in a timely way. We urge you to reject any application of the President's proposed new test to public transportation and to continue in-place the provisions of existing law that allow traditional public transportation facility bonds to be tax-exempt.

A more detailed statement of our views follows for your consideration.

1. The Loss of Tax-Exemption for Public Transportation Bonds Would Keep System Capacity From Being Increased

If the Congress were to approve without any modification the President's proposed "one percent test" for determining the eligibility of proposed municipal bond issues for tax-exemption, the actual effect on our transportation infrastructure over time could be disastrous. As a minimum, the interest cost of issuing and retiring the same face amount of taxable bonds would, according to informed estimates, increase by approximately 30%, or about 250-350 basis points above tax-exempt issues.

Those hundreds of millions of dollars of increased costs conceivably could be recovered over time either through higher charges on area residents, the ultimate users of the facilities, or by local levies on general taxpayers through non-user tax mechanisms.

And it is not certain that those higher costs would be borne just by the residents of the communities sponsoring new transportation facilities. For example, construction of the new Denver Airport may cost $1 billion. Because of the highly competitive nature of airline service through Denver, however, perhaps not all of those costs could be collected from passengers using the Denver Airport. It is likely that some of those costs would be passed onto and collected from all of the passengers of those airlines, including passengers in smaller communities which have no direct service to the Denver Airport.

Alternatively, many projects could be cancelled because their higher carrying costs would make many projects no longer feasible. Or, as likely, the original projects would be undertaken at higher costs and the airlines or ocean carriers would be unable also to help finance additional development at more marginal, probably smaller community, locations.

The most likely result of the President's "one percent test" being adopted is that transportation capital development would decrease by a total amount roughly equal to the increase in interest costs attributable to those issues being classified as "taxable."

-- Volume of Public Transportation Facility Bonds

The volume of bonds issued for public transportation facilities has historically been so small, less than 3% of total long-term tax-exempt issues, that Treasury has combined them and miscellaneous others into a catch-all "other bonds" category.

Historically, airport bonds and seaport bonds have totalled less than $3 billion annually, and past mass transit bonds have been so rare as to be separately unrecorded in overall Treasury totals. Overall, these transportation facility bonds represent a declining percentage share of total long-term bond volume, according to Treasury data.

According to recent industry trade association surveys, the level of proposed long-term tax-exempt financing for public transportation over the next five years will likely remain at about $3 billion per year, measured in current dollars.

About 70% of total airport and seaport capital development anticipated through 1990 would normally come from the tax-exempt markets. And, as the estimates show, the volume of local mass transit investment that might need to be generated through revenue bond issues is hard to project because of the large uncertainties that presently are clouding future Federal transit funding levels.

TABLE

ESTIMATES OF FIVE-YEAR
PUBLIC TRANSPORTATION FACILITY
CAPITAL REQUIREMENTS

(1986 - 1990)

(billions)

| Mode | Total Capital Needed | Share Via Municipal Bond Issues | Annual Bond Volume |
|---|---|---|---|
| Airports | $ 19.4 | $ 13.0 (70%) | $ 2.6 |
| Seaports | $ 5.0 | $ 3.5 (70%) | $ .7 |
| Transit | $ 27.5 | Unknown | Unknown |
| | $ 51.9 | $ 16.5 + | $ 3.3 + |

The pattern of past and projected use is consistent with the public perception, discussed below, that such bonds are "traditional and appropriate" and are not a "new" financing mechanism that some have recently discovered and will attempt to exploit.

2. Providing Public Transportation Facilities is a Traditional Function of State and Local Governments That Has Satisfied Congress' Public Purpose Criteria

In decades past, there were sporadic attempts by the airlines collectively and by marine terminal operators to operate their own airport and seaport facilities independent of local government sponsorship. These were ultimately unsuccessful for a variety of reasons including the inability of private entities to condemn private property for port development purposes; the absence of public police powers with which to control on-site operations; the inability of private operators to operate common use facilities at a profit; and problems in equitably distributing rights to exclusive use facilities among user groups without discord.

Most important of these was the need for a neutral party to allocate available facilities fairly and to arrange to provide additional capacity and facilities in a timely manner. Services to the public, as a result of the private operation of transportation facilities, often were not acceptable.

Thus, decades ago, state and local governnments assumed the sponsorship and regulatory functions of providing and financing common or exclusive use facilities for airport and seaport users so that the travelling or shipping public could be assured of better transportation services.

### -- Congress Has Recognized the Public Purpose Nature of Public Transportation Facilities in Past Tax Laws

In tax legislation going back to 1968 when industrial development bonds (IDBs) were first defined by Congress, the tax-writing Committees of the Congress have consistently recognized the public purpose nature of local public transportation facilities whether operated directly by government entities or leased by those governments so that private transportation companies could provide needed transportation services to the general public.

Legislation enacted in 1968, 1972, 1982 and 1984 has attested to the public nature of transportation facilities. For example, under section 103(n)(7(c)(i) of the existing Internal Revenue Code, enacted last year, bonds issued for airport, seaport and mass transit commuting facilities are separately classified as exempt activity IDBs that need not be counted against the state-by-state volume caps that apply to most other governmentally-issued revenue bonds.

### 3. No Allegations Have Been Made that State and Local Governments Have Abused the Right to Issue Tax-Exempt Bonds for Those Public Transportation Facilities

Because the development of runways, passenger terminals, wharves and docks, and mass transit facilities are locally accepted by the public as traditional public purpose functions of state and local governments, there has been no history of tax controversy surrounding the appropriateness of tax-exempt bonds being issued for these "exempt activities." In addition, neither the Treasury Department nor the Department of Transportation has cited transportation projects as examples of alleged past IDB abuse.

4. The Revenue Loss to Treasury of Continued Tax Exemption for Public Transportation Facility Bonds Is Relatively Small

Since the volume of public transportation bonds is small and even appears to be a declining share of total long-term financings, the projected dollar loss to Treasury from continued tax-exemption is likewise relatively small. It is estimated, based on Treasury data, that the annual revenue loss to Treasury for public transportation bonds issued during any year would approximate $75 million.

The actual revenue loss to Treasury is not reflective of the enormous value of the tax-exempt financing option to state and local governments. As is discussed, many projects needed in the 1986-90 timeframe most likely would not be issued in that timeframe if higher taxable interest rates were the only available capital financing option.

5. Public Transportation Bonds to Finance Even Single Tenant Facilities are in the Public Interest and Should Remain as Eligible as Common Use Facilities for Continued Tax-Exemption

The May 28th Treasury explanation of the President's program suggested that tax exemption should be denied to municipal bonds for airport passenger terminal buildings since the use of those facilities by the general public is different from (less than) the benefit received by the airlines who tenant those terminals.

Our coalition believes that public access to or use of a tax-exempt facility cannot be absolute because of the very nature of those transportation facilities. The public's access to airport runways, for example, must be limited for safety and security reasons although the public's right to non-discriminatory access is guaranteed under Federal law (49 U.S.C. 2210(a)(1) and (2)). Likewise, public access to port facilities is limited by the nature of the activity occurring there. The functions of a port, especially cargo operations with their specialized requirements, are not conducive to general public access. However, it should be understood that the private steamship lines that utilize port facilities are generally common carriers who are required by law (49 U.S.C. App. 1708) to serve the public in a non-discriminatory basis in the carriage of waterborne cargo.

Further, whether a terminal building or a marine terminal facility financed by a tax-exempt bond has a single tenant or has many tenants is immaterial so long as existing Federal laws against economic discrimination or antitrust violations are observed since the available-to-the-public nature of the transportation services would be the same.

Whether an airline or a port terminal operator operates from its own leased unit terminal or shares a common facility with other airport or port tenants is a function mainly of the size of the facility, and the space requirements of various carriers. The common use or exclusive use design of a terminal should not affect the eligibility of the facility for tax-exempt capital financing so long as the governmental entity in each case owns the facility and no non-governmental person benefits from tax ownership of any part of the facility. In smaller cities, in addition, there may be airline service by only one airline so common use facilities at the airport terminal may not be feasible.

6. Administration's Proposed "One Percent Test" for Tax Exemption is Inconsistent With Other Executive Branch Policy Objectives for Transportation

The President's proposed "one percent test" for determining the eligibility of future municipal bonds for tax exemption would classify as taxable (and thus make more costly) future municipal bonds issued:

(a) to finance publicly-owned transit facilities where a private company participates in the local system under contract to and on behalf of the governmental agency; and

(b) to finance additional runway capacity at congested metropolitan area jetports.

In both cases, the proposed "one percent test" would run counter to other Administration objectives for public transportation.

Existing Federal law (49 U.S.C. 1602(e)) and recent Reagan Administration policy positions (49 F.R. 41310, October 22, 1984) explicitly favor increasing the involvement of private enterprise in operating local bus and rail public transit systems. However, since private transit operators would receive longer-than-one-year management or operating contracts using transportation facilities to be financed by municipal bonds, the President's proposed "more-than-one-percent test" could not be met.

Thus, because of the presence of a private operator, the local public agency would be forced to issue more expensive, taxable securities. To frame a test for continued tax exemption that would provide such a huge disincentive to the involvement of private enterprise in mass transit operations runs counter to existing Federal law and articulated Administration policy.

Likewise, in a confused crazy-quilt of contradictory policies, the President's proposed new test for tax-exemption would make the construction of new runways more difficult to achieve at the same time other voices in the Administration are emphasizing how lack of runway capacity already is the critical component limiting civil aviation's orderly development and growth.

As the FAA Administrator told Congress in 1982 when submitting this Administration's $14 billion plan for modernizing the Federal airways system:

> Of all the things that will limit the growth of aviation, it will be concrete or asphalt -- the lack of runway capability. ...It's certain airside congestion is going to get worse since concrete will continue to be the primary limitation. ...Forty-one airports will have severe airside congestion by 1990 and up to 91 airports by the year 2000.

New or extended runways at major airports, as noted earlier, would have to be financed with more expensive taxable bonds under the "one percent test" because airline operations at hundreds of U.S. airports far exceed the allowable one percent of total runway use that could be made available to non-governmental persons while retaining eligibility for Federal tax exemption. The President's tax-exemption test of May 28 would make financing new runways more expensive and thus even more difficult than in 1982 when the FAA made the dire prediction quoted above.

## 7. Other Federal Program Initiatives Could Also Jeopardize Local Projects

If other sources of capital funds for public transportation were to be eliminated or substantially restricted, or other local cost factors increased based on new Federal policies, the potential loss of tax exemption for some or all public transportation facility bonds would be even more harmful to state and local governments.

Among the current concerns of our coalition in this regard are the following:

1. current efforts in the FY'86 Budget Resolution process to restrict Federal capital and operating funds for mass transit;

2. chronic reluctance of the Federal Government to return to airport and mass transit agencies all the Federal user tax receipts already collected from system users for specific airport and mass transit purposes and still retained in Federal transportation trust funds (currently, $306 million for airport and $400-800 million for mass transit);

3. Executive Branch plans, announced in the FY'86 Budget, to "defund" all larger airline-served airports from their present Federal airport grant eligibility (now equalling $400 million per year) from the Airport and Airway Trust Fund starting in FY'87; and

4. new proposals that would require a significantly increased local cost share of Federal channel navigation projects.

To the extent any or all of these initiatives are implemented, continued local governmental access to tax-exempt markets for public transportation infrastructure development would become even more critically important.

CONCLUSIONS AND RECOMMENDATIONS

Mr. Chairman, for all the above reasons, the Committee for Financing Public Transportation Facilities is opposed to the adoption of the President's proposed new "one percent test" for determining whether future public transportation facilities could be financed with tax-exempt bonds.

The short answer is that most public transportation projects could not meet the test. The longer answer is that it is the wrong test and public transportation facilities should be eligible for tax-exempt financing, as in the past.

We urge the Congress to continue to classify as tax-exempt all general obligation and revenue bonds issued for public transportation facilities where those facilities are owned, including for tax purposes, by state and local governments. Public airport, seaport and mass transit facilities serve essential public transportation infrastructure purposes in the same manner as roads and bridges and they should be accorded the same treatment in the Internal Revenue Code.

Under this traditional test, the governmental entity will be considered to own the property that is leased to a non-governmental person (airline, marine terminal operator, private transit company, etc.) notwithstanding the length of the lease period if a number of technical criteria are met that are designed to protect against any possible abuse of the tax-exempt bonding authority.

Legal title must be vested in the governmental entity; no so-called "bargain purchase" would be possible under any leases; there could be no significant front-end loading of any rental payments; and lessees must make irrevocable elections (binding on them and their successors under the lease) not to claim depreciation or investment credit with respect to their property rights in the transportation facility.

At some later time, and depending upon the success of current Administration efforts to encourage "privatization" within public transit, the Congress may wish to determine whether additional tax incentives would be necessary or desirable to help promote that objective for that mode.

We appreciate the opportunity to be heard today and would be pleased to respond to the Committee's questions.

ATTACHMENT

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## STATEMENT BY GEORGE F. DOUGHTY, DIRECTOR OF AVIATION, DENVER, CO

Mr. DOUGHTY. Mr. Chairman, our projections clearly indicate that aviation demand in Denver will require a major new airport facility prior to 1995. The cost of this facility will be at least $1.1 billion in 1985 dollars, with an additional $200 million required for land acquisition.

Current demand will require $200 million be invested in the existing Stapleton Airport before we can get to the new facility.

This demand is the result of Denver's location, its economy; but primarily the deregulation of the airline industry, which has allowed them to use a technique of hubbing and connecting of passengers through major hubs.

The new Denver airport will become the largest public works project in the history of the State. Construction of a facility of this scale is certainly difficult for a number of reasons, and with the loss of tax-exempt financing it would be an added burden that may make the project impossible to build.

Denver is a major example of hundreds of capacity and safety related projects at airports throughout the country that are required to better provide for the air transportation needs of the country. Currently the airport could be constructed from tax-exempt financing, not considered part of the State cap in Colorado. If a cap were applied to these bonds, it would not be possible to build the facility, since it would exceed many times over the current State cap.

Denver's airport is a national and major regional facility, and obviously should not be part of a cap on a single State limit.

Thank you very much.

The CHAIRMAN. Thank you, sir.

Ms. Hayes.

## STATEMENT BY PATRICIA HAYES, PRESIDENT, ST. EDWARDS UNIVERSITY, AUSTIN, TX, ON BEHALF OF THE NATIONAL ASSOCIATION OF INDEPENDENT COLLEGES AND UNIVERSITIES

Ms. HAYES. Mr. Chairman, my name is Pat Hayes, and I am the president of St. Edward's University in Austin, TX. I am grateful for the opportunity to speak with this committee today and am particularly proud that we are represented by a distinguished member of this committee, Senator Bentsen.

I am testifying on behalf of the National Association of Independent Colleges and Universities and all the other educational institutions and organizations that are listed on the prepared testimony.

The National Association of Independent Colleges represents 850 independent institutions in the United States, and the other associations represent every form of educational institution serving this country. We are as a group, and particularly in the independent sector, seriously concerned about the administration's proposal on tax-exempt financing and its impact on higher education.

I will not be reading from my text today, but I would like to summarize the reasons for our concern.

The context for our concern is the longstanding Federal policy on higher education, in which the public and essential purpose of higher education has been set within a dual framework of public and private higher education. That context has been affirmed repeatedly and painstakingly, in fact, in all of the discussions of student aid programs. Within the Tax Code, it is affirmed by the basic tax-exempt status, by the charitable contributions provisions, and most significantly in this case by tax-exempt bond financing.

The administration's proposal is problematic in its technicalities, in its elimination of student loan bonds, but most seriously, in my opinion, in its complete elimination of higher education facilities bonds for the independent colleges.

I would like to talk somewhat about the effects of that provision. The major effect is an enormous disparity between public higher education and independent higher education. It would continue to allow the public institutions of this country to build facilities and deal with pressing facilities problems with tax-exempt financing, but it would discontinue this option for private higher education.

In my own city of Austin, TX—and I will say a little bit more about this later—the irony is that under the administration's proposal, tax-exempt financing would still be available to the University of Texas at Austin, but it would not be available to St. Edward's University. I think my colleagues and good friends at the University of Texas at Austin would find that this was ironic in terms of any goal of fairness in tax reform.

In terms of the facilities problems that higher education faces, the code word that is so much repeated these days is "deferred maintenance." And I think the numbers on that are staggering.

I would just like to expand a little bit on that. In my educational experience, which has been in lower priced institutions serving lower and middle income students, the reason for deferred maintenance is an effort to keep tuitions down and salaries reasonable.

The other parts of deferred maintenance have to do with recently raised consciousness on issues like the handicapped and asbestos and energy and safety of students. So that it is a problem that is not just a bricks and mortar problem. It has to do with the living environment of higher ed.

At St. Edward's, specifically, the tax-exempt bond issue which we just concluded September 5 is for 11 million dollars' worth of projects—one to renovate a 100-year-old building of 52,000 square feet that had been empty for 14 months while we sought a viable financing alternative; the other to build a recreation facility that was 25 years outdated. If we had not had tax-exempt financing, we would not have been able to do these facilities. The additional strain on our budget would have been a half a million dollars a year.

The revenue impact of tax-exempt financing for higher education on the $58 million that goes to nonmunicipal bonds is roughly 2 percent of that total. It is not a major erosion of revenue. In terms of technical considerations, I think time will not permit addressing those; but I think the arbitrage concerns are serious concerns of higher ed but ones that we believe are administratively protected by current regulations.

In summary, Mr. Chairman, I think that we are talking about a philosophical issue in terms of the quality and service of higher education, but we are also talking about higher education as a business operating self-sufficiently. And I think that the higher education tax-exempt bonds allow us to proceed intelligently to provide this service to the country in a way which doesn't come to the government saying, "Just please give us money to solve this problem."

Thank you very much.

The CHAIRMAN. Thank you.

Dr. DuVal.

[Ms. Hayes' written testimony follows:]

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TESTIMONY TO THE COMMITTEE ON FINANCE

U.S. SENATE

PRESENTED BY

PRESIDENT PATRICIA HAYES

ST. EDWARD'S UNIVERSITY

on behalf of

NATIONAL ASSOCIATION OF INDEPENDENT COLLEGES AND UNIVERSITIES

and

ASSOCIATION OF CATHOLIC COLLEGES AND UNIVERSITIES

ASSOCIATION OF JESUIT COLLEGES AND UNIVERSITIES

AMERICAN ASSOCIATION OF STATE COLLEGES AND UNIVERSITIES

ASSOCIATION OF AMERICAN UNIVERSITIES

AMERICAN COUNCIL ON EDUCATION

AMERICAN ASSOCIATION OF COLLEGES ~~OF~~ NURSING

COUNCIL OF INDEPENDENT COLLEGES

NAT'L ASSO OF SCHOOLS & COLL OF THE UNITED METHODIST CHURCH

ASSO OF PRESBYTERIAN COLLEGES AND UNIVERSITIES

NATIONAL ASSO OF COLLEGE & UNIVERSITY BUSINESS OFFICERS

ASSOCIATION OF URBAN UNIVERSITIES

NAT'L ASSO OF STATE UNIV & LAND-GRANT COLLEGES

AMERICAN ASSOCIATION OF DENTAL SCHOOLS

SEPTEMBER 24, 1985

My name is Patricia Hayes and I am President of St. Edward's University in Austin, Texas. I am proud to say that my University is represented by a distinguished member of this Committee, Senator Bentsen. I am here today to testify on the issue of tax-exempt bond financing on behalf of the National Association of Independent Colleges and Universities (NAICU) as well as the other asociations listed on the cover page of my written statement. NAICU represents close to 850 independent, nonprofit institutions of higher education. The other associations listed represent various types of institutions including research universities, state colleges and universities and land-grant colleges and universities. All of these institutions are deeply concerned about the Administration's proposal on tax-exempt bond financing.

For the past several years, the higher education community has fought back various proposals to restrict tax-exempt bond financing utilized to benefit the nation's colleges and universities. Each time, the Congress has recognized the public purposes which colleges and universities serve. Under current law, industrial development and student loan bonds are under a state-by-state cap of $150 per state resident. Bonds issued to provide financing for Section 501(c)(3) organizations are not included in the statewide ceiling. In fact the House Ways and Means Committee report on the 1984 tax bill included the following statement "The Committee believes that private nonprofit organizations (Section 501(c)(3)) should continue to benefit from tax-exempt financing without being forced to compete with private businesses. This is consistent with the general treatment of these organizations, which are exempt from Federal taxes and are (in most cases) entitled to receive tax-deductible contributions. Accordingly, the Committee decided that bonds issued to provide financing for Section 501(c)(3) organizations should not be included in the statewide ceiling." Clearly, such bonds were deemed allowable for public purpose activities which colleges and universities provide.

The Administration proposes to tax interest on obligations issued by a State or local government "if more than one percent of the proceeds were used directly or indirectly by any person other than a State or local government", including a tax-exempt educational entity. Significant changes in the areas of arbitrage and advance refunding would further limit issuance of tax-exempt bonds. The Administration's proposal would eliminate access to the market for private institutions and place restrictions on the issuance of tax-exempt bonds for the benefit of public colleges and universities, a devastating blow to the higher education community. Student loan bonds would be abolished.

We believe that the Administration's proposal to allow tax exemption for governmental activities, while denying it for activities of a tax-exempt educational entity that serves identical public purposes, is arbitrary and misdirected. The creation of such distinctions between private and public institutions would be contrary to a long tradition of diversity and equal treatment in higher education. Public and private colleges would agree that they in fact serve similar purposes and to treat them differently would be abhorrent to the dual system in higher education.

Tax-exempt bonds are utilized by hundreds of colleges and universities, both public and private, for a wide variety of purposes including: construction and renovation of facilities such as libraries, academic buildings, dormitories, athletic centers and student unions; renovation of electrical systems and fire detection systems; major equipment purchases for modernization and research; renovation to provide access to the handicapped; and development of energy management and conservation systems. Access to tax-exempt financing is critical to academic health centers that need clinical teaching facilities, demanding capital in amounts which universities cannot secure in the general market. Considering the many important uses of such financings, the loss of access to the tax-exempt market would be disastrous.

At St. Edward's University we are currently using tax-exempt financing for renovation of our 98 year old main building and for construction of a recreation center to replace a 30 year old gym, built for a student population one-fifth our current size. The main building of 52,000 square feet was empty for almost 2 years because of floor structure problems while we searched for a viable financing mechanism. Without tax-exempt bonds, these two projects would cost St. Edward's University over $500,000 more in debt service each year. In fact, without tax-exempt bonds, we would have postponed the recreation center and begun the main building in phases.

St. Edward's University has a tuition $1700 below the national average and serves almost 30% Hispanic and Black students. We are growing in enrollment because the population we serve is growing, because Austin is growing, and because the University of Texas at Austin has focused its mission on research and the top 20% of undergraduate applicants. Ironically, however, under the Administration's tax proposal, the University of Texas would still have access to tax-exempt bonds (with some restrictions), but St. Edward's would have to bear full market costs of borrowing. Clearly, this kind of disparity is not the goal of tax reform, nor does it serve the national purpose of higher education access and quality.

Tax-exempt bonds provide funds to our non-profit colleges and universities for the execution of clear and essential public purposes. Denial of this traditional and efficient form of financing would produce significant loss to the nation's colleges. Colleges and universities utilize tax-exempt bonds for the traditional kinds of public-purpose activities which the Internal Revenue Code requires as a precondition to tax-exempt status under Section 501(c)(3).

In fact, one rationale for tax-exempt status of nonprofit institutions is that they serve purposes and carry burdens that the government would otherwise bear. The Administration asserts in its proposal that "the issuer of non-governmental bonds would not spend its own revenues to support the activities that are federally subsidized through tax-exempt non-governmental bonds." As applied to higher education, this assertion might be read as a refusal by colleges to use their own funds for educational facilities. Colleges and universities, facing serious budget constraints, would be unable rather than unwilling to finance the costs of loans and facilities, and would thus be unable in this critical respect to fulfill their exempt function of lessening the burden on government.

The Administration's proposal suggests that $95 billion of long-term tax-exempt bonds were issued in 1983 and of that amount, 61%, or $58 billion, were "non-governmental" bonds. In that same year, tax-exempt higher education facilities financings accounted for only 2% of all long-term tax-exempt bonds. The revenues to be gained are not significant enough to outweigh the importance of these public-purpose bonds.

Colleges and universities also utilize tax-exempt bonds to provide capital for student loan programs, including the Guaranteed Student Loan (GSL) program, the secondary market (buying loans from banks to assure necessary liquidity for GSL's), and non-federally guaranteed supplemental loans. Supplemental student loan programs have been designed to fill the gap created by rising costs and limited eligibility for Federal grant and loan programs. As such, they are truly a supplement to - not replacement for - the continuation of the fully funded federal Pell Grants, federal Guaranteed Student Loans and other federal and state student loan programs. It is hard to imagine a more public purpose than the provision of low interest loans to fill the gap which often exists in available capital for needy students. These loans provide an absolutely essential source of funding for the nation's students and their families, helping to ensure access to colleges and universities.

I would also like to address the Administration's proposals in the areas of arbitrage and advance refunding. Funds from tax-exempt issues are sometimes used to purchase higher yielding federal (or other) obligations, the interest of which is not taxable in the hands of the state or local agency, or other tax-exempt non-governmental organization issuing the tax-exempt notes. Similarly, funds from tax-exempt issues are sometimes used to retire an earlier bond issue.

Under both the first instance stated above ("arbitrage bonds"), and the second ("advance refunding"), the tax-exempt issuer seeks to minimize the present cost of outstanding debt by engaging in investing practices which maximize the efficiency of available capital. Through arbitrage, the issuer invests a bond sale's proceeds to the highest short-term return, thereby reducing the long-term costs of the underlying debt issue. By undertaking a refunding, the issuer refinances and restructures debt in such a manner as to likewise reduce the extended costs of carrying long-term debt.

Both arbitrage and advanced refundings provide a means for investment flexibility which ensure that the borrowings and consequential debt of governmental and tax-exempt non-governmental entities most accurately reflect the current value of money. More important, arbitrage and advanced refundings provide a means by which debt issuing entities can reduce their debt load and borrowing dependency on governmental bodies. This diminished dependency, which results from the ability to more flexibly invest, permits the tax-exempt entity to draw less on direct state and local subsidies and more on the competitive investing marketplace.

The Administration proposes to severely restrict the degree to which tax-exempt entities, in general, can engage in arbitrage practice, and also to prohibit the practice of advance refunding for all tax-exempt bonds. In support of these measures the Administration points out that arbitrage increases the volume of tax-exempt bonds, (bacause arbitrage tends to reduce interest financing costs), and that such volume increases result in less revenue to the federal treasury. Advanced refundings, it is suggested, are likewise undesireable because they too increase the volume of tax-exempt bonds and the corresponding federal revenue loss.

As can be seen from the legislative history of the arbitrage provisions and the development of arbitrage regulations, these same arguments were historically put forward and have continued to be relied upon as reasons for limiting the use of arbitrage. The enactment of Section

103(c) of the Code and subsequent amendments to the arbitrage provisions, including limitations added by the recent Deficit Reduction Act of 1984, as well as the stringent regulations promulgated to implement the statute, have, we respectfully submit, more than adequately dealt with the perceived problems which the Administration asserts warrant the proposed action. Other pending reform tax bills must also recognize these issues are sufficiently addressed under existing law, since none of them propose any changes or additions to the arbitrage provisions or to those provisions dealing with advance refundings.

Better efficiency and utilization of public dollars is brought about by continuing to permit tax-exempt entities to engage in arbitrage and refundings. Moreover, continuation of the existing system will encourage higher education institutions to further develop their financial skills so that future bond issues are more precisely measured to financial need. The present system has served to encourage a more efficient utilization of capital, thereby enhancing the fiscal independence from the federal government, and financial integrity, of colleges and universities.

Mr. Chairman, the colleges and universities of this nation provide the means by which this nation has prospered over the years. We attempt to offer the highest quality of education and excellence possible. If we are unable to provide adequate facilities and financing of higher education, we cannot maintain that excellence. If public and independent institutions are treated differently for purposes of tax policy, we cannot maintain the healthy atmosphere of competition between and among institutions. I ask this Committee to once again recognize and reconfirm the Congress' commitment to higher education. I thank you for allowing me to appear before this distinguished Committee and would be happy to answer any questions you may have.

## STATEMENT OF MERLIN K. DuVAL, M.D., PRESIDENT, AMERICAN HEALTHCARE INSTITUTE, WASHINGTON, DC

Dr. DuVal. Mr. Chairman, I will simply make a brief summation of a written commentary that has been submitted for the record.

I would start by observing that the voluntary community hospital is an organization that, as you know, precedes even the American Revolution in this Nation. And while most of its heritage is religious, whether Presbyterian, Methodist, Evangelical, Adventist, or Catholic, today they still offer the full profile of the needed public services in their communities, irrespective of ability to pay, and they still dispense at this time in the Nation most of the Nation's uncompensated care.

All business—and a hospital is a business—need access to capital for meeting life and safety codes—it has been a long time since we picked up the paper and read about a patient in a hospital fire—for renovation, for modernization, for reconfiguration of the industry in order to meet the changing needs of the public and the changing technologies that are available.

We would ask the question: How does a hospital get access to capital? I would answer that there are three types of hospitals in these United States, at least at this time. The for-profit organization achieves access to capital through the equity markets by the sale of stock and by taxable debt instruments; the public institutions—that is to say governmental—use tax appropriations and tax-exempt bonds; the voluntary community hospitals, their only access with the loss of philanthropy and government grants has been through tax-exempt bonds.

By virtue of this, it seems to us that it is inappropriate public policy to consider eliminating tax-exempt bonds for voluntary hospitals. If these institutions are denied access to tax-exempt bond funding, there is no question that but some will totally lose access to capital; while, for the others the cost of capital, the cost of money, the cost of rendering services will of course increase.

The Federal gains by eliminating this tax expenditure will be at least in part offset by the increased expenditures that are transferred to Medicare, and this will represent the first step toward the possible conversion of the voluntary not-for-profit institutions in the United States either to public or possible to for-profit status.

I would submit, sir, that the voluntary community hospital has a very long and very venerable, most trusted history in the United States. It is my petition to you today that, for us to take any risk that may culminate in the dismantling of this institution in exchange for a very small short-term fiscal gain is not going to be in the public interest.

Thank you very much.

[Dr. DuVal's written testimony follows:]

American
Healthcare
Institute

Affiliated with American Healthcare Systems

Merlin K DuVal, M D
President

STATEMENT OF THE

AMERICAN HEALTHCARE INSTITUTE

before the

COMMITTEE ON FINANCE
UNITED STATES SENATE

on the

IMPACT OF TAX REFORM ON TAX-EXEMPT BONDS

September 24, 1985

Mr. Chairman, I am Merlin K. DuVal, M.D., President of the American Healthcare Institute. The American Healthcare Institute represents a national network of 34 voluntary healthcare systems that provide quality hospital and other health services in communities throughout 44 of our United States. The members that comprise this network, known as American Healthcare Systems, own, lease or manage 361 hospitals and provide contract services for another 831. On behalf of our member systems, I appreciate this opportunity to share our views about the impact of one element of the President's proposed tax reform program on America's voluntary hospitals.

We are concerned, Mr. Chairman, that the proposed tax reform package recommends changes in the tax code which, in our judgment, could seriously impair the ability of many voluntary, not-for-profit hospitals to continue to meet their traditional community responsibilities. As you know, voluntary not-for-profit hospitals serve the public purpose by providing a full range of health care services to all the patients in their communities. Such facilities are committed to serving the needs of all patients, by subsidizing the care of those who cannot pay. It is this history of public purpose that has led the Government to grant such hospitals 501(c)(3) tax status in the Federal code. It is this same sense of public purpose that justifies special recognition regarding the use of tax-exempt bond financing to help these institutions meet their capital needs at a reasonable cost.

The President's tax plan, however, proposes to limit access to tax-exempt bond financing almost exclusively to debt obligations issued by State and local governmental entities. Such a step--if approved by this Committee and the Congress--threatens the most important source of capital currently available to the country's voluntary hospital system.

Permit me, for a moment, to review why tax-exempt financing is so important to the non-profit, non-governmental hospital sector. Until the mid-1960s, most hospitals in the United States were able to meet their requirements for capital for replacement and renovation from a variety of sources. Philanthropy, grants from public appropriations, and funds generated from internal operations were all important sources of these funds. In contrast, public hospitals, then as now, were supported directly through the taxing power of their owners.

In 1965, Congress enacted the Medicare and Medicaid programs, placing major new demands on the voluntary hospital industry to provide quality care for the elderly and the poor. As the demand from the public for services grew, public grants declined. Those provided by the Hill-Burton program were first significantly reduced, and eventually eliminated altogether as a source of capital. Philanthropy became less and less able to make a major contribution toward the capital needs of an expanding and increasingly technologically complex industry. Of necessity, hospital management began to explore ways to use their internal sources of funds. Long-term borrowing arrangements, which could be repaid with internally-generated capital, became the principal instrument for meeting growing capital needs. Meanwhile, the Government itself adopted a number of policies that encouraged management to focus attention on debt financing as the principal source of capital financing for not-for-profit voluntary hospitals. For example, the Government's reimbursement policies under Medicare and Medicaid--cost-based payment rules--made it impossible to accumulate earnings (equity) from Federal reimbursement for capital purposes.

For the non-profit hospitals, tax-exempt bond financing represented, as it does today, an approach for meeting capital requirements in a cost-effective manner. Such financing offers lower interest costs than taxable instruments, generally provides for longer payback periods, and makes it possible for hospitals to maximize the use of scarce donated funds and other equity to secure borrowed capital. To facilitate the use of this type of financing, most States created statutory authorities for issuing tax-exempt bonds to aid non-profit hospitals in meeting their capital requirements. Tax-exempt financing is now the single most important source of capital for voluntary hospitals.

We are concerned, Mr. Chairman, about the impact the President's tax reform plan will have on capital formation in the non-profit hospital industry--an industry that is undergoing rapid and major structural changes. Clearly, capital is needed for the maintenance of facilities and the replacement and renovation of worn-out plants. But, capital is also required to facilitate transformation of our indsutry into more efficient care delivery units. Our member hospital systems have become acutely aware of the need to reorganize the traditional ways in which health services are being provided, to consolidate current resources, and to develop new ambulatory resources to meet the health needs of the public in an increasingly competitive environment.

Tax-exempt hospital capital projects in most communities today serve a variety of purposes:

- renovation of older, existing facilities;
- construction of lower cost ambulatory alternatives to inpatient facilities;

- reorganization and consolidation of existing inpatient services and the introduction of new or highly specialized services (e.g., trauma centers, burn units, etc);
- development of ancillary and support services; and,
- mergers and integration of separate facilities into more cost-effective care delivery units.

Regrettably, some casual observers of what is happening in today's health care industry continue to believe that the bulk of capital spending goes to support expanded capacity and unneeded new services. Nothing could be further from the truth. There's a new competitive world out there, encouraged both by government and private purchasers of health care, that will not support wasteful use of capital resources. Falling occupancy rates and shorter lengths of stay (which reduce hospital revenues), competition from ambulatory care providers, and fixed rates of payment, mean that managers who add unneeded capacity or unwanted services would imperil themselves financially.

Eliminating access by non-profit hospitals to tax-exempt financing will have a number of consequences. The use of tax-exempt financing permits facilities to keep their charges down and better preserve their underlying financial condition. Conventional financing alternatives will clearly mean higher interest rates and shorter repayment periods. Debt service costs will, of course, increase. If a hospital is to maintain its previous financial position, charges to patients will have to be increased. However, if either the marketplace or regulatory constraints preclude such action, the financial position of the hospital will decline.

Non-profit hospitals are not in business to increase earnings. Many of them, in fact, are operating very close to the margin. Demand for services has slowed. Purchasers of services--including the Federal government--continue to "ratchet down" amounts paid for the care of public patients. If the cost of capital rises significantly, to taxable levels, some hospitals could be shorted out of the capital market altogether.

In these commmunities, Mr. Chairman, hospital managers will have the painful task of deciding how and whether to continue to offer the full range of hospital services--including those that operate at a loss--to all members of the community. If you approve the President's Tax Reform proposal in the form it has been offered, and thereby bar some of these institutions from access to capital, this will not alter their very real growing need for capital resources. Erecting such a bar will only divide our hospitals into "haves" and "haye nots" with sad consequences for America's voluntary hospital system and for the people they serve.

There are now, after all, Mr. Chairman, three kinds of hospitals in the United States--voluntary non-profit facilities, governmentally-operated public hospitals, and for-profit entities. If access to tax-exempt financing is eliminated, there will be an increased trend to a system with only two categories. How can the voluntary sector be expected to meet its traditional public responsibilities and survive in such an environment? Some may even ask why should voluntary hospitals take on such burdens if the government--through its elected representatives--no longer sees any distinction to their efforts?

For these reasons, Mr. Chairman, we urge your Committee to reject the Administration's undifferentiated approach to dealing with the capital needs of voluntary, not-for-profit hospitals. Thank you for your attention and consideration.

The CHAIRMAN. Go right ahead, Mr. Owen.

## STATEMENT OF JACK W. OWEN, EXECUTIVE VICE PRESIDENT, AMERICAN HOSPITAL ASSOCIATION, WASHINGTON, DC

Mr. OWEN. Thank you, Mr. Chairman.

I am Jack Owen. I represent the American Hospital Association, and I just would like to make about four or five points, following up on Dr. DuVal's comments on the tax-exempt bond issue.

First, although we are large employers in many communities and our institutions are concerned with health policy, and we have some concerns about a number of things in a tax-reform bill, our first priority is tax-exempt bonds, and that is the only thing I am going to address today.

Second, we have just gone through some cuts in the Senate Finance Committee markup on Medicare. As you well know, hospitals have done a good job in these past 3 years with the new system, working closely with Congress. Health care costs have gone down, and we think that this policy in tax reform of removing tax-exempt bonds is a step backward in what we just accomplished 2 weeks ago in reducing the dollars that would be paid out by Medicare. Because if the tax-exempt bonds are gone, the interest rates go up, and Medicare, again, has to pay a higher rate.

Hospitals will receive lower credit ratings in taxable markets, which increase the interest costs, and Medicare and Medicaid are going to be the ones who are going to pay at least 40 percent of that.

So, when you look at the revenue that the Treasury gets and the expenditures that the Federal Government gets in tax-exempt hospitals, the offset is very close.

As Dr. DuVal said, access to capital will be denied. Corporate markets are very different between the investor owned and the nonprofit. And it would be difficult for many hospitals to obtain sufficient credit readiness, especially those hospitals who are located in inner-city areas.

Charitable nonprofit organizations cannot and should not be compared to forprofit institutions. They have in many cases lower operating margins; they are faced with public and private payor constraints, and the hospital's primary purpose is to serve community needs.

Third, you asked about public purpose, and I think that almost every community that I know of, government, is responsible for shelter and food and healthcare to some extent for their citizens. And in many cases, these communities do not provide tax-supported hospitals but rely on nonprofit hospitals to take care of citizens of their community, and the quid pro quo of that has been to allow those hospitals to have tax-exempt bond financing to keep them up to date, and to allow them to provide the services that those communities need.

So, I think that it is unquestionable in my mind that hospitals in a nonprofit area provide a public service to most governmental units.

Last, I would just like to say that we are going through a phase in this whole financing of health care—the whole problem of capital, which came up at the hearing on return on equity, and all the other things that are involved in what we do with capital. And it seems to me that this is the wrong time and the wrong place to change the system on tax-exempt bonds, when we still don't know how we are going to include the price of capital in the DRG system.

I will quit with that, Mr. Chairman.

[Mr. Owen's written testimony follows:]

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## STATEMENT OF THE AMERICAN HOSPITAL ASSOCIATION BEFORE THE COMMITTEE ON FINANCE UNITED STATES SENATE ON THE IMPACT OF THE PRESIDENT'S PROPOSAL FOR COMPREHENSIVE TAX REFORM ON TAX-EXEMPT FINANCING FOR NONPROFIT HOSPITALS

September 24, 1985

### SUMMARY

The American Hospital Association (AHA) strongly opposes the provision contained in the President's proposal for comprehensive tax reform that would eliminate tax-exempt financing for nonprofit hospitals. If enacted, this proposal would deny access to capital markets for many nonprofit hospitals. It also would raise the costs of capital used to modernize, renovate, and upgrade those institutions able to raise capital in the taxable market.

Hospitals serve a critical public purpose by providing high quality health care services to their communities, often at no charge to the indigent. Hospitals also serve society through their educational and research activities.

The ability of hospitals to continue to provide high quality medical care depends heavily upon success at capital formation. Capital projects are primarily undertaken for modernization and restructuring of outstanding debt, keeping facilities in compliance with life and safety codes, and financing the purchase of sophisticated medical equipment.

Given the dramatic changes occurring in the hospital field as a result of the implementation of the Medicare prospective pricing system and an increasingly competitive environment, the Association believes it would be shortsighted to make further fundamental changes in the system--such as eliminating the principal source of capital financing for nonprofit hospitals--during this period of adjustment.

## INTRODUCTION

Mr. Chairman, I am Jack W. Owen, executive vice president of the American Hospital Association and director of its Washington Office. The AHA represents over 6,100 member hospitals and health care institutions, as well as approximately 38,000 personal members. We are pleased to have this opportunity to present our views on the impact of the President's proposal for comprehensive tax reform on tax-exempt financing for nonprofit hospitals.

The President's proposal includes a provision that would eliminate tax-exempt bond use by nongovernmental, nonprofit hospitals. Specifically, the plan proposes repeal of the exemption from federal income tax of interest on bonds used by nongovernmental, nonprofit entities. If enacted, this proposal would seriously jeopardize access to capital markets for many nonprofit hospitals and would raise the costs of capital for those institutions able to raise capital in the taxable market. Moreover, it would threaten the existence of hospitals that have substantial commitments to serve the poor and that already are financially vulnerable.

Such a proposal would have a devastating impact on nongovernmental, nonprofit hospitals. These institutions, which comprise 58 percent of the nation's community hospitals, have been historically rooted in the not-for-profit sector and viewed as charitable organizations fulfilling an indispensable community service.

## HISTORICAL PERSPECTIVE

Over many years, the charitable nature of the vast majority of the nation's hospitals has been reflected through the tax-exempt status of nonprofit hospitals and the substantial public and private support such hospitals have received for capital financing. Prior to World War II, hospitals received most of their capital financing through the philanthropy of individuals and religious groups, as well as through the financial assistance of local governments. Together, these sources provided two-thirds of the capital support required by hospitals.

Public support for the nation's nonprofit hospital system was firmly established in 1946 with the passage of the Hill-Burton program which provided grants and low-interest loans for hospital construction. Thus, with a heightened postwar awareness of the need to assure access to health care, a major public commitment was made to the modernization and expansion of the nongovernmental, nonprofit hospital system as the focal point for the delivery of health care services to communities. The Hill-Burton program remained a grant program until 1970 when it was converted to a loan and loan-guarantee program. Before it was eliminated in the late 1970s, it provided about $4 billion in grants to nearly 4,000 hospitals and $1.9 billion in loan and loan guarantees to almost 300 hospitals.

The federal government, and eventually state governments, continued to support access to capital for nonprofit hospitals by allowing them to use the proceeds from tax-exempt bonds, a less expensive source of capital than taxable debt. In 1963, the Internal Revenue Service (IRS) issued IRS Ruling 63-20 which permitted nonprofit hospitals to issue tax-exempt bonds through a municipality. However, this ruling required that ownership of a facility be turned over to the city or county when the bonds were retired. Subsequently, state laws were enacted that allowed hospitals to issue tax-exempt debt through state and/or local bodies, but did not impose the transfer of ownership requirement. Therefore, access to tax-exempt financing by nonprofit hospitals was facilitated and firmly established at the local level, and recognition of the essential public purpose and charitable mission of these hospitals was recognized by all levels of government.

In the mid-1960s, the federal government fundamentally changed the nature of its support for the health care system. With the enactment of the Medicare and Medicaid programs, and the subsequent reduction and eventual elimination of the Hill-Burton program in the late 1970s, direct federal support for the financing of buildings and equipment shiftsd to the direct purchase of services. Medicare and Medicaid, in combination with the growth of private health insurance plans, provided a stable cash flow, giving hospitals the financial foundation and security necessary to secure debt and meet capital financing needs.

In addition, both the Federal Housing Administration and the Farmer's Home Administration also provided support for some hospitals in securing debt. In 1968, Section 242 was added to the National Housing Act, authorizing the

Federal Housing Administration to provide mortgage insurance for loans to some nonprofit hospitals. While later extended to governmental and investor-owned hospitals, this insurance has been used almost exclusively by nongovernmental, nonprofit hospitals. In 1974, legislation was enacted to provide low-interest loans to rural health facilities through the Farmer's Home Administration (P.L.92-419). Although this program has since been reduced in scope, it again demonstrated the historical support of government for the capital financing of nonprofit hospitals.

With this strong government support, nonprofit hospitals increasingly have relied upon tax-exempt debt financing for their capital needs.

## VOLUME OF HOSPITAL TAX-EXEMPT DEBT

Reliance on debt for major hospital construction projects increased from 67.3 percent in 1975 to 75.8 percent in 1981. In 1981, 78 percent of that debt was in the form of tax-exempt bonds, and hospitals used $5.16 billion in tax-exempt bonds, representing 11.19 percent of the tax-exempt market. In 1982, hospitals accounted for $9.71 billion or 12.88 percent of the total tax-exempt market. While the dollar volume of hospital tax-exempt bonds issued has increased steadily, its portion of the entire tax-exempt market has decreased since 1982. The following table illustrates the volume of hospital issuances of tax-exempt bonds from 1980-1984 in aggregate, and as a proportion of the total tax-exempt market.

| | Total hospital tax-exempt bonds issued (in billions) | Percentage of total tax-exempt Market |
|---|---|---|
| 1980 | $3.56 | 7.55% |
| 1981 | 5.16 | 11.19 |
| 1982 | 9.71 | 12.88 |
| 1983 | 9.94 | 11.93 |
| 1984 | 10.23 | 10.00 |

While the volume of hospital tax-exempt bonds nearly doubled from 1981 to 1982, and has remained at record levels, there is no evidence that hospitals are abusing this source of capital. Three factors can be cited as largely influencing the recent heavy use of the tax-exempt market.

First, a drop in interest rates during the second half of 1982 brought into the market many hospitals which had been delaying needed projects. In January 1982, a typical hospital bond issue yielded approximately 15 percent, while in September 1982, yields were less than 10 percent. By year's end, hospital debt yielded about 11 percent, and in May 1983 hospital tax-exempt debt was yielding between 9.5 percent and 10 percent.

Second, because of declining interest rates, some hospitals which had entered the market earlier chose to refinance (re-fund) their outstanding debt at more favorable rates. In 1982, re-funding alone is estimated to have accounted for 4.5 percent of total hospital tax-exempt issues. Re-funding activities in 1983 represented 27 percent of overall market volume. This figure dropped to 6.9 percent in 1984 and can be expected to drop further inasmuch as most hospitals now have finished refinancing their outstanding debts which carried higher rates of interest. Of course, if interest rates should drop further to a level that would make additional refinancing worthwhile, the proportion of refinancings could again increase. It is important to note that refinancing at lower rates also reduces Medicare costs because interest payments are consequently reduced.

Finally, hospital construction and equipment costs in general have significantly increased. New technology, as well as new life and safety code requirements have made it much more costly for hospitals to maintain their facilities at appropriate levels. These factors have influenced the increased need for capital and contributed to higher tax-exempt debt volume in recent years.

## Use of Capital

Changes in the economy and in health benefit coverage, as well as specific legislative and regulatory actions, also have influenced the direction of capital financing. In addition, the demand for capital will continue to grow as facilities constructed in the 1950s and 1960s become outmoded and need renovation and replacement. Therefore, the health care system will be challenged continually to ensure access to capital financing if hospitals are to maintain facilities and equipment necessary in the delivery of high quality services.

The vast majority of hospital capital projects are used for modernization projects needed to replace or renovate facilities; restructuring of outstanding debt; keeping facilities in compliance with life and safety codes; and financing the purchase of sophisticated medical equipment. These are legitimate and necessary projects that require capital and are necessary for the continued delivery of high quality health care services--but add no new beds to the existing health care delivery system. In fact, the total number of staffed hospital beds declined nationwide by 2.2 percent from 999,614 in March 1984 to 977,606 in March 1985.

It is not true, as some contend, that the growing use of tax-exempt financing by hospitals has contributed to an increase in the construction of new hospital beds. According to the AHA's 1983 Hospital Capital Finance Survey, modernization projects consumed the largest portion of hospital construction activity, while only 21 percent was used for new buildings, many of which were used for replacment as opposed to expansion projects.

## Checks on Capital Expenditures

It is important to recognize that significant changes occurring in the health care marketplace also have an impact on hospital capital expenditures. For example, the recent enactment of the Medicare prospective pricing system helps ensure that capital expenditures are made only for necessary purposes.

The new Medicare system, which changed payments for operating costs to hospitals from cost-based reimbursement to pricing based on diagnosis-related groups (DRGs), along with other sharp payment restrictions by state governments and private payers, has changed hospital incentives. These changes require institutions to be even more cautious in capital spending because subsequent operating revenues are not guaranteed to support their capital assets.

In addition, existing federal health planning authority and many state regulatory agencies continue to monitor the need for major capital expenditures by hospitals. Most states still require certificate-of-need (CON) review to verify the need for capital expenditures, including major medical equipment purchases, and new institutional health services proposed by hospitals. CON approval of projects also is taken into consideration by bankers and state bonding authorities in making decisions to approve or deny tax-exempt financing for hospital projects.

## IMPACT OF ELIMINATION OF TAX-EXEMPT BONDS

The elimination of tax-exempt bonds would force nonprofit hospitals to pursue other financing arrangements such as taxable debt instruments, which are not only more difficult to obtain but also are more costly than tax-exempt instruments. As a result, hospital costs would increase and most hospitals would attempt to pass all or some of the cost increases onto third-party payers, including government, and to patients. However, some, if not many hospitals, particularly those providing substantial services to the poor and facing increased payment constraints from various payers may be unable or unwilling to pay these additional costs.

Moreover, under current payment policies, Medicare and Medicaid include payment to hospitals for certain capital costs associated with caring for beneficiaries of these programs. Therefore, since Medicare and Medicaid are obligated to absorb such additional costs, some of the revenues that would be gained by the federal government through the proposed tax policy change would be somewhat offset by higher payments to providers.

Increased Costs

Estimates of exactly how much costs would increase in a taxable market vary greatly, depending upon assumptions related to interest rates and the value of bonds issued. For example, if tax-exempt bonds issued in 1984 had been issued in taxable markets, increased costs could have varied from as much as $160 million to over $300 million. The lower estimate presumes an interest rate differential of 163 basis points, which is the difference in 1984 between the average Merrill Lynch tax-exempt hospital bond rate of 10.65 and the average Standard and Poor's corporate bond index of 12.28. However, many bond market experts believe that hospital bonds would carry higher interest rates than the Standard and Poor's index because of lower credit ratings they would receive in the taxable market.

Moreover, the amount of additional interest hospitals would have to pay in the taxable credit market would accumulate in future years if taxable bonds were issued to fund the substantial capital requirements of hospitals.

## Overall Capital Needs

Many forecasters have predicted hospital capital needs for the 1980s well in excess of $100 billion. These substantial capital requirements and shortfalls in available funding suggest that capital may well be the most critical issue facing the hospital field today.

Much current hospital capacity was built during the 1950s and 1960s and is entering the stage at which major renovation or replacement is needed. As previously stated, modernization projects continue to consume the largest portion of hospital construction activity. However, other factors affecting hospital capital needs also must be considered in light of tax policy. These include the aging of the population and increased health needs over a longer life-span, and population shifts, such as moves to sun belt states which create greater burdens on some facilities.

## Access in Taxable Market

There are serious questions about nonprofit hospital accessibility to the taxable bond market. It is important to recognize that the corporate bond market is very different from the tax-exempt bond market because the investors are different. The major purchasers of bonds in the taxable market are large institutions while the major purchasers of bonds in the tax-exempt market are individuals. A clear danger is that institutional investors will not respond positively to bonds that are sold by charitable organizations such as nonprofit hospitals because such institutions tend to have low operating margins resulting from public and private sector payer constraints, as well as charity care obligations. Moreover, hospital bond issues are comparatively small and may be overshadowed by larger corporate issues.

In addition, hospitals are not likely to receive credit ratings in the taxable market as high as those received in the tax-exempt market. Because of higher interest rates in the taxable market, hospitals' projected debt coverage could be lower, resulting in lower credit ratings.

Under the President's proposal, nonprofit hospitals would have to compete for capital with organizations whose primary goal is stockholder profit--organizations that would reflect healthier financial performance and receive better credit ratings. For example, some hospitals with large endowments, hospitals that are highly liquid, and/or those that have large proportions of privately insured patients and minimal Medicaid and free-care obligations potentially could receive adequate credit ratings and qualify for competitive interest rates. However, the bulk of nonprofit hospitals, on which large numbers of the poor and near-poor rely for care, either would not be able to achieve ratings on the bond market or would receive unfavorable credit ratings--ratings that would permit issuance of bonds only at prohibitive interest rates. Such institutions include rural hospitals and inner-city hospitals that often are the sole providers of health care services in their communities.

## PUBLIC PURPOSE

The AHA strongly believes that nongovermental, nonprofit hospitals serve a vital public purpose in providing high quality health care services to communities. The vast majority of hospitals in this nation provide essential and highly complex services, often at no charge to the poor and medically indigent. In 1983, community hospitals provided $7.8 billion in uncompensated care. Bad debt and charity care as a percent of gross patient revenue constituted 5.4 percent of such revenue in 1983 and have increased each year over the past four years. In addition, hospitals serve society through their educational and research activities, and play a vital role in volunteer activities and the exercise of community values, moral and ethical.

The President's proposal would allow bonds used by governmental entities such as public hospitals to retain their tax-exempt status unless more than 1 percent of the proceeds would be used directly or indirectly by any person other than a state or local government. However, the plan does not specifically define how this rule would be applied, and the AHA is concerned that too strict an application might jeopardize tax-exempt financing for public hospitals.

Moreover, the AHA believes that nongovernmental, nonprofit hospitals--like their public hospital counterparts--unquestionably serve a public purpose. In fact, there are many communities in which public hospitals do not exist, and nongovernmental, nonprofit institutions are the sole providers of vital health care services. The financial status of such hospitals, which is the key to their survival, is a proper concern of public policymakers and a principle of government's commitment to the health care system.

While nonprofit hospitals that are financially healthy may be able to use debt financing options other than tax-exempt bonds, financially weak hospitals generally are unable to use those alternatives and might be denied access to capital if tax-exempt financing were not available. Such hospitals typically provide substantial amounts of charity care or serve high proportions of Medicare and Medicaid beneficiaries and low-income patients. They usually are small and located in rural, isolated areas, or are large hospitals located in inner cities. As a matter of public policy, Congress should not penalize these institutions which are most committed to serving the elderly and poor.

## REDUCED FLEXIBILITY IN THE USE OF TAX-EXEMPT BONDS

The President's proposal contains provisions that would eliminate advance re-fundings and severely limit arbitrage for tax-exempt bonds. Through these mechanisms hospitals have been able to achieve substantial savings and needed flexibility in managing their capital portfolios. The proposed restrictions on these mechanisms would limit the ability of nongovernmental, nonprofit hospitals, as well as public hospitals, to manage their capital effectively. This translates into a higher cost of capital for the hospital, and results in higher-cost health care services for the community served by the hospital, as well as increased costs to the major purchasers of hospital care, including the federal government.

Equally, if not more important, restrictions on re-fundings and arbitrage would prevent many hospitals from responding to rapidly changing health care needs in their communities by preventing them from excercising cost-effective capital management techniques.

## Advance Re-funding

The increased competitiveness of capital markets and changes in the health care delivery system have caused many hospitals to restructure their long-term debt portfolios. Hospitals increasingly must manage their debt on an ongoing basis. However, most hospital bonds have provisions that do not allow retirement prior to maturity until about ten years after the original issuance. Consequently, many hospitals have bonds only a few years old that have unusually high interest rates and/or bond covenants that restrict them from achieving more cost-effective long-term debt management. As a result, hospitals have used advanced re-fundings to restructure debt and reduce costs.

Advance re-funding allows hospitals to establish a secured escrow account with re-funding bonds to repay debt service on a prior issue. In this manner, if interest rates drop, hospitals can take advantage of the lower interest rates made available through re-funding bonds, and--since repayment of the prior issue is secured--free themselves from overly restrictive bond convenants of a prior issue. Thus, through advance re-funding, hospitals can reduce debt service, improve cash flow, and increase financial flexibility.

## Arbitrage

Arbitrage also is used by hospitals in the management of debt portfolios. This mechanism already is restricted under current law and is not used by hospitals to earn significant revenues that are directed toward non-tax-exempt purposes. When employed, arbitrage helps reduce debt service at critical points in the funding or re-funding of a bond issue. Again, this allows hospitals to provide more services to their communities at lower cost.

For example, the use of arbitrage during the temporary period when construction is underway can significantly lower debt service during the period prior to use of a new facility. Also, allowing as "permissable arbitrage" accommodation for administrative expenses in the yield calculations of a bond refinancing makes it financially feasible for a hospital to reduce debt service costs and increase flexibility at critical times.

## IMPACT OF REDUCED CHARITABLE GIVING

While charitable contributions have decreased substantially as a source of construction funding for nonprofit hospitals, the amount of philanthropy received by hospitals is substantial. In 1984, it is estimated that the health and hospital field received $10.4 billion in charitable contributions or 14.0 percent of total philanthropic gifts nationwide--almost 90 percent of which were given by individuals. Among recipients of charitable contributions, the health and hospital category ranks second behind religious organizations, followed by the educational field.

The AHA is opposed to the provision contained in the President's tax reform plan which would repeal the charitable deduction for non-itemizers. It not only threatens to reduce the proportion of giving by individuals to charitable organizations but is inconsistent with the President's often-stated policy of encouraging private giving by individuals and corporations to help finance social, educational, and health programs, particularly those that have suffered substantial reductions in federal support. Private philanthropy supports activities that are merited and in the public interest. Moreover, it reflects and fosters a highly desirable attitude by individuals toward the needs of their communities.

## CONCLUSION

The nation's nonprofit hospitals as well as their access to capital have been firmly supported both by public policy and private giving. The President's proposal for comprehensive tax reform contradicts this historical commitment and fails to recognize the practical realities of both the current health care marketplace and the problems confronting nonprofit hospitals in taxable corporate debt markets.

Over the past few years we have witnessed dramatic changes in the health care marketplace. The enactment of the prospective pricing system in 1983 precipitated the most revolutionary changes in health care financing since the creation of the Medicare program. Given these dramatic changes, the full impact of which is still largely unknown, it would be shortsighted to make further fundamental changes to the system--such as eliminating the principal source of capital financing for nonprofit hospitals--during this period of adjustment.

Neither the federal government nor the public would be well served by hindering the ability of nonprofit hospitals to maintain and upgrade their facilities adequately so that access to quality health care may be ensured. The revenues realized by the federal government by the elimination of tax-exempt bonds for nonprofit hospitals would be insignificant in comparison to the costs that inevitably would result from failure to maintain the nation's hospital infrastructure.

The need for capital over the next decade is one of the most crucial issues facing hospitals. With the declining role of philanthropy and government grants in financing hospital capital needs, and the limited opportunities to generate capital through patient services, tax-exempt bonds have become the most cost-effective method of capital financing.

Most importantly, the nongovernmental, nonprofit hospital sector, which meets a majority of this nation's hospital care needs, is made up of institutions serving a public purpose in their communities. Thus, facilitating access to tax-exempt financing is an appropriate and positive tax policy in the public interest.

The CHAIRMAN. Mr. Owen, do proprietary hospitals serve a public purpose?

Mr. OWEN. Yes, they do. They serve the public purpose and in many cases they do a very good job. However, their purpose is also to serve their stockholder, and we don't see too many investor-owned hospitals moving into inner-city areas where there is a poor and needy population.

The CHAIRMAN. If they serve a public purpose, should they have access to tax-exempt bonding?

Mr. OWEN. No, I don't think so, because they have access to the capital market through stocks and through that capital approach, they have it much better—it is not even a fair competition, because the nonprofit is borrowing dollar for dollar, where the investor-owned, for each dollar of equity that they build, they have more borrowing power. So they have an opportunity to borrow larger sums of money and obtain more capital than the nonprofit does.

The CHAIRMAN. In that case, as we move toward privatizing other public services and allow profitmaking companies to collect garbage or move freight or do things that public entities used to do, should they be denied access, then, to tax-exempt markets?

Mr. OWEN. Well, again I would go back to the hospital side, which I know better. There are investor-owned hospitals that manage municipal and tax-exempts, and I would see that as the same approach as a company coming in to manage garbage, or a prison, as the case might be. I don't see any difference there; but that is different than issuing those. There the governmental agency or the nonprofit agency—.

The CHAIRMAN. But now we are coming close. When they come in to manage the hospital, should they as part of that management be able to issue tax-exempt bonds for that hospital?

Mr. OWEN. I would say my personal opinion would be no, that that is the job of the people who own that hospital and not the manager either of a public or a nonprofit organization that is the controlling body of the institution. They are contracting with a company to provide the private management, not the financing.

The CHAIRMAN. Mr. Anderson, let me move back to this issue of industrial development bonds, which is one you are familiar with. Are any jobs created that would not otherwise be created because of industrial development bonds?

Mr. ANDERSON. On some small operations I would respond the same way Mr. Rutherford did. Of the let's say 300 million dollars' worth of revenue bonds that we have had go through our port authority to private investors, I would say 95 percent of them are going to be built whether or not they use industrial revenue bonds. The Crown Zellerbachs, Weyerhousers, Reynolds Aluminums, and others who have come in and used those kinds of bonds are getting the cheapest money in town.

The CHAIRMAN. Well, you can all very clearly see the problem we are toying with. Frankly, I think hospitals are going to be all right, and I think Mr. Durig's disposal of solid waste is clearly a public function. I talked with you before, Lloyd, about wharves, and docks, and airports, and what not. Clearly it is a public function. And if education isn't a public function, I don't know what is. If that isn't serving at least a public purpose, then nothing serves a public purpose. The fact that it may be provided by my college which was Willamette and probably belongs to your association, Ms. Hayes, or not would not make much difference in terms of education; it is education and the public is saved money by our doing it. And the Government has $200 billion deficits. I am trying to figure out how to harmonize them.

I don't have any other questions, but I appreciate it very much. Thank you.

[Whereupon, at 11:05 a.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

# TESTIMONY BY SENATOR PETE WILSON

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

## IMPACT OF THE PRESIDENT'S TAX REFORM PROPOSALS

TUESDAY, SEPTEMBER 24, 1985

MR. CHAIRMAN, I VERY MUCH APPRECIATE THE OPPORTUNITY TO SUBMIT TESTIMONY TO YOUR COMMITTEE AS IT INVESTIGATES THE IMPACT OF THE PRESIDENT'S TAX REFORM PROPOSALS, PARTICULARLY, TAX-EXEMPT BONDS, ON STATE AND LOCAL GOVERNMENTS.

MR. CHAIRMAN, MY PURPOSE IS NOT TO MAKE SPECIFIC RECOMMENDATIONS REGARDING TAX-EXEMPT BONDS AND FINANCING BUT TO HIGHLIGHT THE MANY CONCERNS OF LOCAL GOVERNMENTS IN CALIFORNIA AND OF THE STATE GOVERNMENT. IT IS MY HOPE THAT THIS INFORMATION WILL BE HELPFUL TO YOU AND THE COMMITTEE AS YOU CONTINUE YOUR EFFORTS FOR REVENUE NEUTRAL TAX-REFORM.

BUT FIRST, LET ME SAY THAT WHILE I APPRECIATE THE NEED TO BRING GREATER FAIRNESS TO OUR TAX SYSTEM, WHICH HAS LAUNCHED THE EFFORT FOR TAX-REFORM, SIGNIFICANT FURTHER DEFICIT REDUCTION IS A FAR MORE URGENT PRIORITY THAN TAX-REFORM. WITH BUDGET DEFICITS EXPECTED TO INCREASE, DESPITE THIS YEAR'S REDUCTION EFFORTS, BY $500 BILLION OVER THE NEXT THREE YEARS, THE SAVINGS GENERATED BY THE ADMINISTRATION'S TAX PLAN TO REPEAL THE TAX-EXEMPT STATUS OF STATE AND LOCAL BONDS WILL NOT COVER THE INTEREST ON THIS FRIGHTENINGLY GROWING DEBT. UNTIL REAL DEFICIT-REDUCTION IS ACHIEVED, WE FACE THE GRAVE DANGER OF RE-IGNITING INTEREST RATES AND INFLATION. WE MUST NOT SHIFT OUR FOCUS AND PRIORITIES TO TAX-REFORM.

WE HAVE NOT COMPLETED THE ALL-IMPORTANT TASK OF DEFICIT REDUCTION. WE DARE NOT DELUDE OURSELVES THAT WE HAVE. NOR CAN WE AFFORD TO ALLOW OURSELVES TO BE DIVERTED FROM THAT TASK. ALL THE TAX REFORM PROPOSALS OFFERED THIS YEAR HAVE PROPOSED TO BE REVENUE-NEUTRAL -- MAKING EACH IRRELEVANT TO DEFICIT REDUCTION.

MR. CHAIRMAN, ONLY WHEN WE HAVE ACHIEVED REAL DEFICIT REDUCTION CAN WE TURN OUR ATTENTION TO THE SEVERAL REVENUE-NEUTRAL TAX REFORM PACKAGES WHICH HAVE BEEN OFFERED THIS YEAR IN THE NAME OF GREATER FAIRNESS TO TAXPAYERS. AND THEN, EVEN AS CONGRESS PURSUES TAX EQUITY, IT MUST GIVE THE MOST CAREFUL CONSIDERATION TO THE IMPACT THAT ANY PROPOSED REFORM WILL HAVE ON THE ABILITY OF THE VARIOUS STATE AND LOCAL GOVERNMENTS THROUGHOUT THIS COUNTRY TO MEET THEIR NEEDS AND RESPONSIBILITIES.

WE MUST BE CAREFUL THAT OUR WELL-INTENDED "REFORMS" DO NOT UNJUSTLY IMPAIR THE ABILITY OF STATE AND LOCAL GOVERNMENTS TO MEET THEIR RESPONSIBILITIES. AS A FORMER MAYOR, I KNOW FIRST-HAND THE VITAL IMPORTANCE OF TAX-EXEMPT BONDS TO FINANCE THE ESSENTIAL CAPITAL IMPROVEMENT PROGRAMS OF LOCAL GOVERNMENTS, PARTICULARLY IN THIS ERA OF NEW FEDERALISM AND REDUCED FEDERAL GRANT PROGRAMS FOR THAT PURPOSE.

AS NEW FEDERALISM CONTINUES TO EVOLVE AND STATE AND LOCAL GOVERNMENTS SHOULDER GREATER RESPONSIBILITIES AND COSTS, CONGRESS SHOULD NOT ELIMINATE THE VERY TOOLS THAT OUR LOCAL GOVERNMENTS AND STATES HAVE RELIED UPON TO FINANCE NOT THEIR NEW, BUT THEIR TRADITIONAL RESPONSIBILITIES -- PARTICULARLY WHEN OTHER CONGRESSIONAL ACTIONS THREATEN TO SIGNIFICANTLY INCREASE STATE AND LOCAL BUDGETS FOR BOTH OPERATING AND CAPITAL PROGRAMS.

IF I MAY FOR A MOMENT, I WOULD LIKE TO DRAW THE COMMITTEE'S ATTENTION TO A SUMMARY OF BUDGET REDUCTIONS AND MANDATES THAT MAY POTENTIALLY EFFECT STATE AND LOCAL GOVERNMENTS. OUR EFFORTS FOR DEFICIT REDUCTION HAVE RESULTED IN THE LOSS OF GENERAL REVENUE SHARING, AND REDUCTIONS IN MANY OTHER CITY PROGRAMS. THE SUPREME COURT HAS RULED THAT STATE AND LOCAL GOVERNMENTS MUST COMPLY WITH THE FAIR LABOR STANDARDS ACT (FLSA). CONGRESS IS CONSIDERING MANDATING MEDICARE AND SOCIAL SECURITY FOR STATE AND LOCAL GOVERNMENTS. ADDITIONALLY, TAX REFORM PROPOSALS WOULD RESTRICT MANY BONDING AND FINANCING TOOLS USED BY THESE GOVERNMENTS WHILE AT THE SAME TIME ELIMINATING DEDUCTIBILITY OF STATE AND LOCAL TAXES.

THE TOTAL EFFECT OF ALL THESE CHANGES CAN BE DEVASTATING TO ANY LOCAL GOVERNMENT. A RECENT STUDY BY THE CITY OF LOS ANGELES INDICATES THAT REVENUE SHARING AND LOCAL PROGRAM REDUCTIONS WILL COST MORE THAN $65 MILLION, FLSA WILL COST $70 MILLION, MEDICARE AND SOCIAL SECURITY COVERAGE $20 MILLION, TAX-EXEMPT BOND CHANGES $60 MILLION, AND ADVANCED REFUNDING $15 MILLION. THE TOTAL COST OF ALL THESE CHANGES IS A STAGGERING $275 MILLION ANNUAL INC5REASE TO THE CITY'S COMBINED OPERATING AND CAPITAL BUDGET. IN ADDITION, THE LOSS OF THE DEDUCTION OF STATE AND LOCAL TAXES COULD TAKE $129 MILLION OUT OF THE LOS ANGELES ECONOMY.

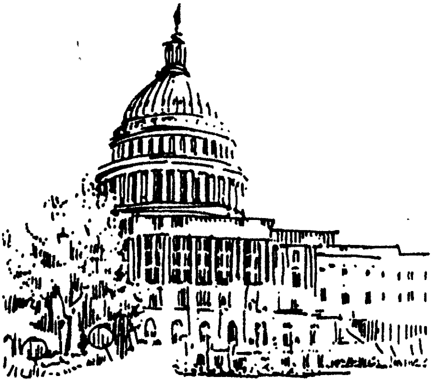
MORE SERIOUS BY FAR, THE JOINT ECONOMIC COMMITTEE RECENTLY IDENTIFIED CAPITAL FINANCING NEEDS NATION-WIDE OF $1.1 TRILLION THROUGH THE YEAR 2000, OR $73 BILLION ANNUALLY FOR THE EXTENSION AND RENEWAL OF AMERICA'S VITAL INFRASTRUCTURE. THE BOND PROVISIONS IN THE ADMINISTRATION'S TAX BILL WOULD SERIOUSLY THREATEN THE ABILITY OF STATE AND LOCAL GOVERNMENTS TO GENERATE THE NEEDED CAPITAL INVESTMENT AND ALMOST SURELY PREVENT ESSENTIAL INFRASTRUCTURE EXPENDITURES.

THE SIGNIFICANT TOOLS THAT CALIFORNIA LOCALITIES RELY UPON INCLUDE: INDUSTRIAL DEVELOPMENT BONDS, TAX INCREMENT OR TAX ALLOCATION BONDS, REVENUE BONDS, AND ADVANCED REFUNDING.

I AM NOT ADVOCATING ANY PARTICULAR TAX-EXEMPT BOND MECHANISM OVER ANOTHER. MY INTENT SIMPLY IS TO PROVIDE A PERSPECTIVE OF THE IMPORTANCE OF THESE MUNICIPAL FINANCING MECHANISMS TO THE CAPITAL AND INFRASTRUCTURE NEEDS OF OUR STATE AND LOCAL GOVERNMENTS. FURTHER, I BELIEVE THAT TAX REFORM CHANGES CANNOT BE VIEWED INDEPENDENTLY OF OTHER RECENT CONGRESSIONAL AND JUDICIAL ACTIONS WHICH ARE IMPACTING STATE AND LOCAL GOVERNMENTS.

MR. CHAIRMAN, THE TASK OF TAX REFORM IS DIFFICULT, PARTICULARLY WHEN THE PROJECTED FISCAL IMPACTS ARE SUBJECT TO DEBATE. A REPORT BY THE UNITED STATES CONFERENCE OF MAYORS PROJECTS THAT THE LOSS OF TAX-EXEMPT BONDS WILL INCREASE THE TOTAL CAPITAL COSTS FOR LOCAL GOVERNMENTS BY 50-100%; HOWEVER,ESTIMATES OF THE FEDERAL REVENUE TO BE GAINED BY ELIMINATING TAX-EXEMPT BONDS VARY GREATLY. THE TREASURY DEPARTMENT ESTIMATES $13 BILLION GENERATED OVER THE NEXT FIVE YEARS, WHILE A COOPERS AND LYBRAND STUDY CONCLUDES THAT ONLY $2 BILLION WILL BE GENERATED.

IT IS CLEAR THAT STATE AND LOCAL GOVERNMENTS SHOULD AND WILL BEAR THEIR FAIR SHARE OF THE BURDEN. HOWEVER, IT IS ALSO CLEAR THAT THE IMPACT OF DEFICIT-REDUCTION, TAX REFORM, FLSA, AND MEDICARE CHANGES FAR EXCEED THE LOCAL GOVERNMENT FAIR SHARE.



# Statement of the
# American Health Care Association

TAX-EXEMPT FINANCING IS CRITICAL TO NURSING HOMES
FOR CAPITAL FORMATION AND MEETING LONG TERM HEALTH CARE NEEDS

TESTIMONY BEFORE THE

U.S. SENATE
COMMITTEE ON FINACE

ahca
American Health Care Association 1200 15th Street, Washington, DC 20005 (202) 833-2050
For Futher Information Contact: William Hermelin or Thomas Jazwiecki

## AMERICAN HEALTH CARE ASSOCIATION

### Tax-Exempt Financing is Critical to Nursing Homes for Capital Formation and Meeting Long Term Health Care Needs

The American Health Care Association, representing more than 8,000 proprietary and nonproprietary nursing homes throughout the United States, is pleased to present its views on the impact of tax reform proposals on tax exempt bonds to the Senate Finance Committee. We believe tax-exempt bond financing must be retained if the long term health care needs of this nation's elderly and infirmed are to be met. The demand for long term care services already exceeds the supply of nursing home beds and demographic trends indicate this demand will increase significantly in the future. Tax- exempt bond financing is not only critical to developing the required capital resources to meet the nation's growing long term health care needs but will inherently contain capital financing costs and thus control public program expenditures under Medicare and Medicaid. We believe private tax-exempt entity bond financing and small issue industrial development bonds should be retained for nursing homes and other public purpose health care providers.

**The Need for Nursing Home Services: Current and Future**

Nursing homes shoulder a heavy public responsibility by providing health care and housing services to our nation's frail elderly and disabled. There are approximately 13,300 nursing homes certified under Medicare of Medicaid providing more than 1.3 million skilled or intermediate care beds to the neediest and most vulnerable of populations.

Residents of nursing homes require a wide variety of medical and social services. All require health care treatment, ranging from complex to routine. A recent epidemiological study done by Johns Hopkins University and Medical School indicates that upwards of 60-70 percent of all patients residing in nursing homes may be victims of the tragic Alzheimer's Disease or other related disorders. Eighteen percent of patients have ambulatory problems. Twenty-two percent of patients require full assistance in eating. Forty-eight percent are incontinent.

In most communities throughout the country, the nation's approximately 20,000 nursing homes serve a purpose beyond providing care for the dependent elderly and chronically ill. The nursing home industry is labor intensive and provides extensive employment opportunities. Every 100 nursing home beds currently create the need for 63 full-time equivalent employees. About 750,000 new jobs will be created if the projected bed needs are met by the year 2000.

These new jobs create opportunities for employees and the community. New employees become a productive and skilled labor resource in the community capable of meeting future gerontological and health care service needs of the growing number of elderly. The wage and facility tax base becomes a productive and economic asset to not only state and local government, but the federal government as well. Each new facility can be expected to generate thousands of dollars annually in additional tax revenues from, income, payroll, sales, excise, and other state, federal or locally imposed taxes. And nursing homes are a economic resource for the community as a principal purchaser of goods and services.

There is an extremely high level of dependency on public assistance programs to help pay for nursing home services. More than 2 out every 3 resident of nursing homes are on Medicaid. Medicaid is by far the single large public payor for nursing home services. Approximately 45 percent of all nursing home expenditures are financed with Medicaid program assistance, approximately 2 percent from Medicare and another 4 percent from other federal programs such as the Veterans Administration.

During the next two decades, a profound change will occur in the makeup of the U.S. that will significantly increase the need for long term care services. By the year 2000, 13.1 percent of American citizens will be over 65. Six-and-one-half percent will be over 75. Alone, these statistics may not seem significant. However, what is significant are projections showing that in a mere 15 years the 75-84 age group will increase from 7.7 to 12.2 million, while the 85 and over population will more than double -- from 2.2 to 5.1 million (see exhibits I and II). It is anticipated that 1 out of 5 individuals over age 75 will need nursing home care.

Statistics also show that the rate of nursing home use increases dramatically with age: for individuals over 85, the utilization rate if 23 percent; for the 75-84 age group, the rate is six percent; for the 65-74 population, utilization is two percent (see exhibit III). These rates are closely tied to the fact that older seniors are prone to chronic disabilities and therefore have greater need for supportive services. Trends show and studies confirm that as the population ages, the need for long term care increases. Independent researchers have documented that an additional 1.2 million nursing home beds will be needed by the year 2000 just to maintain the present age-specific level of service. In practical terms, a 120-bed nursing home would need to open each day through 2000 just to meet the projected demand for care (see exhibit IV).

Using a cost base of $25,000 per bed and an annual inflation rate of 6 percent, a $60 billion capital investment would be needed to maintain current service capacity. Because more than 70 percent of all nursing homes are at least 20-years i, the price tag would, in fact, be significantly higher -- due to renovation costs.

At the same time that the number of dependent elderly is increasing, the ratio of nursing home beds to aged population is decreasing. The primary reasons for the lack of growth in bed supply are twofold:

- inadequate Medicare and Medicaid reimbursement levels make capital investment unattractive, and

- artificial constraints have been placed on bed supply through health planning restrictions and certificate of need (CON) moratoriums.

Nursing homes currently are having difficulty attracting private capital investment. Several states, under the pressure of budgetary shortfalls, have constrained Medicaid reimbursement, imposed building moratoriums, and created a fiscal climate that raises apprehension in the investment community over capital funding for nursing homes. When available, investment capital is usually at more expensive financing rates because of risk premiums associated with nursing home investments. Federal policies must respond to these constraints if the elderly are to have access to services.

## Use of Tax-Exempt Financing by the Nursing Home Industry

On May 29, 1985, President Reagan released his proposals for major federal tax reform. As part of this tax reform, interest on obligations issued by a state of local government would be taxable if more than one percent of the proceeds were used directly or indirectly by any person other than a state or local government. The President's proposal would eliminate the federal tax exemption for all "private purpose" or non-governmental uses of such obligations, effective for obligations issued on or after January 1, 1986. Thus, the proposal effectively eliminates tax exempt bond financing for all non-governmental usage.

To make tax-exempt financing even more unattractive, and --as a corollary-- to eliminate non-governmental tax-exempt financing, the Administration's tax package also includes proposals to deny a favorable interest deduction for banks, thrifts, and other financial institutions carrying tax-exempt obligations. Currently, these institutions receive an 80 percent deduction for interest expense incurred to carry or purchase tax-exempt obligations. This deduction is a significant incentive for financial institutions to carry tax-exempt obligations. The Administration's proposal will eliminate this interest deduction for financial institutions acquiring tax-exempt obligations after December 31, 1985.

Elimination of tax-exempt bond financing for private purpose use will have a particularly serious impact on nursing homes. Tax-exempt bond financing has become the major source of capital financing for nursing homes. Such financing obligations have reduced the effective overall cost of capital on borrowed funds, has made capital formation more possible and has helped control program expenditure levels for public health care programs like Medicare and Medicaid. If tax-exempt financing mechanisms are no longer available for nursing homes, the sources of capital will become more competitive, the cost of capital is likely to increase, thus adding greater cost to public health care programs like Medicare and Medicaid, and the ability to meet nursing home bed requirements for the future will become highly uncertain.

Nursing homes primarily use two types of tax-exempt financing obligations to pay for the cost of capital financing for new construction, renovation, and expansion to meet community long term care needs:

1. private tax-exempt entity bonds, and

2. small issue industrial development bonds.

The form of tax-exempt bond financing used heavily by non-profit health care organizations is the private purpose tax-exempt entity obligation. These private tax-exempt entity bonds are obligations of organizations having tax-exempt status under Internal Revenue Code Section 501(c)(3). Approximately $11 billion of the almost $12 billion face value of tax-exempt entity bond financing issued in 1983 were for private non-profit hospitals and nursing homes.

The other form of tax-exempt obligations scheduled to be eliminated in January 1986 under the President's tax reform that will affect nursing homes are small issue industrial development bonds (IDBs). Small issue IDBs, which are primarily used by proprietary nursing homes, were also curtailed severely by the 1984 Tax Reform Act with per capita and per user limitations. Small issue IDBs presently are scheduled for elimination on December 31, 1986.

A recent Treasury Department announcement will accelerate this timetable to December 31, 1985, for obligations secured by letters of credit issued by banks whose deposits are insured by the Federal Deposit Insurance Corporation (FDIC). Small issue IDBs have been the primary source of capital financing for proprietary nursing homes during the past several years. The face volume of small issue IDBs issued in 1983 was approximately $15 billion. About $1.6 billion of this amount was for medical and health entities such as nursing homes.

The federal government directly benefits from the use of tax-exempt financing by nursing homes. The resultant reduction in nursing home capital financing costs in conjunction with the restrictions on use of accelerated depreciation result in lower operating costs, thus increased net operating income and greater treasury tax revenues. In addition, Medicare and Medicaid pay less through lower reimbursement levels for capital costs. An probably most important in terms of fiscal savings, the potential to save significant of dollars in added and inappropriate expenditures for patients backed-up in hospitals awaiting nursing home placement is directly proportional to the availability of nursing home beds. The General Accounting Office has estimated that Medicare and Medicaid annually pay for up to 9.2 million days of inpatient hospital care on behalf of patients who only require a level of care that could appropriately be provided in a nursing home. Since these inappropriate costs are already built-in to our acute care system, added costs are being incurred by both Medicare and Medicaid, and other third party payors, as well, for such inappropriate services. The capacity of the nursing home industry to expand and accommodate the inappropriately placed patients can significantly reduce overall expenditures on health care services.

Recommendation

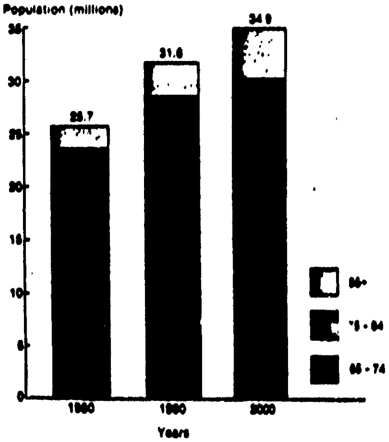
AHCA urges the Congress to retain tax-exempt bond financing for nursing homes and other appropriate health care providers. Both tax-exempt entity bonds for non-profit facilities and the small issue IDBs primarily used by proprietary nursing homes should be retained under federal tax law. In addition, the current Internal Revenue Code provision enacted under the 1984 Tax Reform Act to eliminate the use of small issue IDBs after December 31, 1986, should be deleted to allow their continued use.

As an alternative to retaining tax-exempt bond financing for nursing homes and other designated health care providers under the "small issue" provision, a definition of "public purpose" could be restructured so as to include those providers who participate in any federal or state sponsored public health care or assistance program.

In addition, as a corollary recommendation, the current favorable tax treatment afforded financial institutions to carry public purpose tax-exempt obligations should also be retained to encourage their continued participation in carrying such obligations.

## Exhibit I

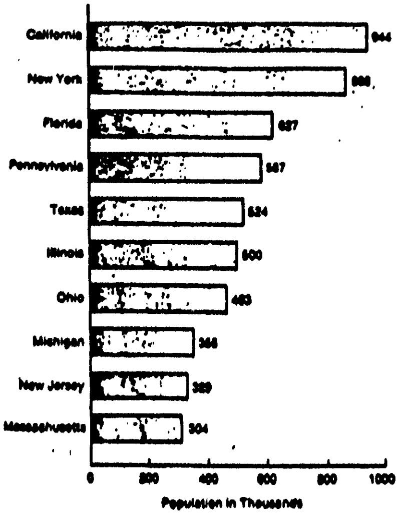
### Elderly Population Projections, 1980 - 2000



U.S. Census Bureau, "Projections of the Population in the U.S.," Series P-25, No. 952, May 1984

## Exhibit II

### Population 75 Years and Older Top 10 States



U.S. Bureau of the Census, Demographic and Socioeconomic Aspects of Aging in the U.S., Series P-23, No. 138 8/84

## Exhibit III

### Nursing Home Population by Age Groups

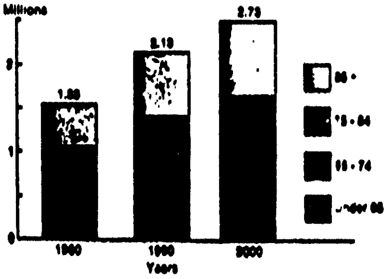
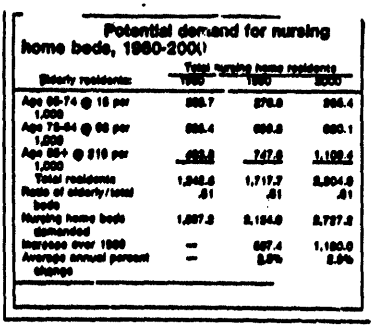


Exhibit IV



**Potential demand for nursing home beds, 1980-2000[1]**

| Elderly residents: | Total nursing home residents 1980 | 1990 | 2000 |
|---|---|---|---|
| Age 65-74 @ 15 per 1,000 | [illegible] | 276.6 | 296.4 |
| Age 75-84 @ 66 per 1,000 | 586.4 | 696.8 | 880.1 |
| Age 85+ @ 219 per 1,000 | [illegible] | 747.6 | 1,109.4 |
| Total residents | 1,248.6 | 1,717.7 | 2,204.9 |
| Ratio of elderly/total beds | .81 | .81 | .81 |
| Nursing home beds demanded | 1,637.2 | 2,124.8 | 2,737.2 |
| Increase over 1980 | — | 487.4 | 1,100.0 |
| Average annual percent change | — | 2.6% | 2.6% |

Source: Health Care Financial Management, "The Capital Requirements for Long Term Care," by John Valiante, ICF Inc., April 84, p. 86.

AMERICAN PROTESTANT HEALTH ASSOCIATION

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TELEPHONE (312) 843 2701

Charles D Phillips Ed D
President

# STATEMENT OF

# THE AMERICAN PROTESTANT HEALTH ASSOCIATION

# ON THE NECESSITY OF TAX-EXEMPT BONDS

# FOR NOT-FOR-PROFIT HOSPITALS

SEPTEMBER 24, 1985

The American Protestant Health Association (APHA) is comprised of 300 hospitals, agencies and nursing homes across the country with 2000 personal members in in its division, the College of Chaplains. The APHA has hospitals in 38 states, totalling 60,000 beds and its hospitals are located in both rural communities and the inner cities. Although the APHA hospitals are church related, they receive little or no direct financial support from the church. As an indivisible part of their religious committment, the APHA hospitals serve large proportions of Medicare, Medicaid and medically indigent patients. In addition, all APHA hospitals are not-for-profit entities and, accordingly, would be seriously affected by the proposed repeal of the tax exemption for not-for-profit hospital bonds.

Private not-for-profit hospitals serve a long recognized and vital function by providing quality health care to our communities. In fact, a large percentage of our nation's health care is provided by such hospitals. In addition to the quantity of health care provided by not-for-profit hospitals, these institutions also provide greatly needed services such as rehabilitation, outpatient and alcoholism and drug treatment. Not-for-profit hospitals, including APHA hospitals, also provide high quality health care services to a large proportion of Medicare, Medicaid and medically indigent patients.

In the past, not-for-profit hospitals relied on government assistance for financing. For example, the Hill-Burton program provided Federal grants, low interest loans, and loan guarantees for not-for-profit hospitals. That program, however, has been terminated. Although charitable contributions also provided much needed funding for not-for-profit entities, such contributions have been dwindling. The Administration's proposed elimination of the charitable deduction for those who do not itemize will further erode such contributions. The Medicare and Medicaid programs, which also provide reimbursement for capital costs, are being revamped with potentially adverse consequences on hospitals' capital expenditures. Thus, hospitals are left increasingly to rely on debt to finance their operations. A large percentage of that debt is tax-exempt bonds.

While funds are decreasing, the costs of necessary capital projects are increasing. For instance, rapid technological advances are increasing necessary equipment costs. In addition, replacement, renovation and modernization construction of facilities built in the 1950's and 1960's is much more costly than the original construction. Consequently, the aggregate of changes in hospitals' revenue pictures are threatening the financial stability of not-for-profit institutions.

Significantly, hospitals have used and are using capital obtained primarily to modernize and renovate old facilities, to replace Medical equipment necessary to provide high quality care and to refinance existing debt. The bulk ot capital expenditures, thus, are used to maintain and modernize facilities--not to increase new hospital beds.

The elimination of the tax exemption for not-for-profit hospital bonds would have drastic consequences on such hospitals. Indeed, hospitals with an insufficient credit standing would be precluded from the taxable bond market. Particularly threatened would be hospitals least able to raise capital in the taxable market, such as inner-city hospitals and rural hospitals in distressed areas and the hospitals that serve large numbers ot Medicare, Medicaid and medically indigent patients. Even those hospitals that are currently financially sound and able to raise capital in the taxable market would tace increased debt service costs and eventually be foreclosed from raising necessary capital to ensure the continued provision of quality medical services.

The result would be that with the passage of time, hospitals would not be able to modernize, renovate or expand. In addition, the hospitals would have to make due with less at a time when their tinancial viability is further being threatened by burgeoning uncompensated or charity care pressures. Not only would the not-tor-protit tacilities suffer, but the patients who so dearly rely upon the provision of health care services would bear the brunt ot the elimination of tax-exempt financing. Physical plants will deteriorate and some patients will be deprived of up-to-date equipment and technology. In addition, access to health care services for medically indigent patients who are uninsured or underinsured would be curtailed. Even now, the growing number of uninsured or underinsured patients is beginning to place great strain on certain hospitals in light of the increasing pressures embodied in the PPS and Medicaid reductions as well as in State, local and private health insurance cutbacks. The repeal of tax exempt financing turther would disrupt the hospital industry and result in the deterioration ot high quality health care and in the sharp reduction of medical care tor the medically indigent. It would also be a major tactor in accelerating the conversion ot the not-tor-protit hospitals to tor-profit status.

For these reasons, the APHA urges the Congress to retain the tax-exemption tor not-tor-protit hospital bonds. Continuation of this exemption would only marginally affect Treasury's general revenues, while the elimination of such financing may tend to increase costs to the Medicare program. The APHA wishes to stress that it will continue to work with the Congress and the Administration to devise a tax code which will serve to reform the present system without jeopardizing the financial stability of not-for-profit hospitals and the availability and quality ot necessary and appropriate health services.

STATEMENT
of the
AMERICAN PUBLIC POWER ASSOCIATION
on
Chapter 11 of The President's Tax Proposal's to the Congress for Fairness Growth and Simplicity

before the
Senate Committee on Finance

September 24, 1985

The American Public Power Association, the national service organization representing approximately 1,750 municipal and other local publicly owned electric power systems nationwide, submits the following statement on the impact of the President's tax proposal on public power's use of tax exempt financing.

Although publicly owned electric utilities serve about 13.4 percent of the electric meters in the United States, they are an important element in this Nation's pluralistic electric industry. They serve approximately 2,200 communities located in forty-nine states.

Public power is a traditional public purpose issuer of tax exempt bonds. Community owned electric utility systems date back to the inception of central station_electric service in the early 1880's, and many public power projects predate school, water and sewage service in their localities. Last year, public power systems accounted for approximately eleven percent of the total $101 billion of long-term tax-exempt bond issues.

In recent years, many small public power systems have joined together to form "joint action agencies." These agencies often are formed in order to plan and build efficient size power plants to meet the projected needs of their members. Sometimes the same end is accomplished by buying a share of a plant owned by an investor owned utility or a rural electric cooperative. Over the past decade, thirty-two joint action agencies have issued tax-exempt bonds to finance electric power supply programs serving over 700 communities in twenty-five states.

Under the guise of tax reform, the President's May 1985 tax proposals would impose severe restrictions on the issuance of tax-exempt bonds by State and local governments. While nominally aimed at abuses of nongovernmental use of tax-exempt financing, the proposals are so indiscriminate that they represent a serious threat to all traditional government financing, including public power, and would make such financing more costly. Public power's operations would be restricted and its ability to operate efficiently and competitively would be weakened, resulting in higher costs for consumers.

Five specific provisions of the President's tax proposals are particularly inimical to the interests of public power:

1. Interest on obligations issued by State and local governments would be taxable if more than one percent of the proceeds were used directly or indirectly by any person other than a State or local government. This change would severely restrict the flexibility of public power systems

to construct or acquire economically scaled electric generating facilities in advance of their need for the full output of such projects. Many of the economically beneficial joint action agency projects of the past fifteen years would have been hampered and made more costly had this proposal been in effect.

2. Any facility operated under a management contract by a private party for a term of more than one year would be ineligible for tax-exempt financing. This proposal would undermine many economically advantageous cooperative ventures between publicly-owned electric systems and investor owned utilities and rural electric cooperatives.

3. Arbitrage regulations would be tightened and, in general, arbitrage earnings would have to be rebated to the U.S. Government. This proposal would increase the amount of financing necessary for most projects and would result in higher costs to consumers.

4. All advance refundings of tax-exempt bond issues would be prohibited. This would reduce issuers' flexibility to restructure debt service and manage capital expenditures efficiently. Consumer costs would increase.

5. All governmental bonds would be subject to burdensome reporting requirements. Failure to file would result in loss of tax exemption. Detailed reporting of this kind was first developed to allow monitoring and control of abuses in the issuance of private purpose industrial development bonds. The attempt to impose such requirements on public purpose tax-exempt financing is in no way related to the legitimate notion of "tax reform."

In addition, public power is concerned that if a tax simplification bill is not approved before the President's recommended enactment date of January 1, 1986, that any changes be made only on a prospective basis and, also, that adequate transition rules be included to protect the tax exempt status of projects already underway.

A more detailed discussion of each of these points follows.

One-Percent Rule

Under the proposed "one-percent rule" the interest on obligations issued by a State or local government would be taxable if more than one percent of the proceeds were used directly or indirectly by any person other than a State or local government. Generally, use of a facility financed with the proceeds of tax-exempt obligations would be considered to be use of the proceeds.

The one-percent limit is far too indiscriminate in its effects. In a purported attempt to eliminate the excessive use of tax-exempt financing by nongovernmental parties, the proposal places new restrictions on traditional government financing that will make such financing more costly, and in the case of public power, will result in the loss of economic efficiency. Examples of economically desirable arrangements that could be curtailed include long-term sales of capacity to investor owned utilities and industrial customers, and sell-backs of power and energy by publicly owned utilities when they purchase an ownership interest in a generating plant from a private party.

Under current law, publicly-owned electric power systems may issue tax-exempt obligations to finance the construction of generation, transmission, and distribution facilities, or to purchase an ownership share of such facilities in joint arrangements with nonexempt persons. Public power systems may also enter into contractual arrangements whereby nonexempt parties agree to take or pay for a portion of the output from a facility financed by the public system. Typically, these private parties may be investor owned electric utilities, rural electric cooperatives, or large industrial customers. However, the portion of the output that the public system may sell to nonexempt parties over the life of the bond issue is limited to 25 percent.

The ability of a publicly owned utility to sell some of the output of a plant during its early years of operation allows the utility to provide for expected growth of its own needs in an efficient manner. For example, for a utility estimating its power supply needs for 1995, prudent planning necessitates that it construct facilities that will provide more than enough power for its system in 1986 or 1990. This type of planning is traditional in the electric utility industry, and economically imperative for facilities that have relatively long lead times. Selling excess capacity that is available during the early years of operation of a new facility allows utilities to take advantage of the economies of scale inherent in electric generation and maximize the efficient use of the nation's electric energy system.

The proposed one-percent limit is arbitrary and ignores the basic economic and technical realities of providing electric energy from publicly owned facilities. Electric power plants take from five to twelve years to build and come into service in relatively large increments. While the demand for electric power in a utility's service area may grow at an annual rate of 2 to 3 percent, it is generally impractical and inefficient to add electric generating facilities at this rate.

This is not unique to the power industry. Any industry planning capacity additions based on projections of future needs will construct larger facilities than necessary for its immediate needs. Faced with excess capacity in the short-run, prudent managers will try to minimize the amount of unused plant. In the electric power industry managers do this by selling the excess output in the early years. This prevents resources from remaining idle and lowers the cost of electric power to all consumers. The one-percent limit would virtually eliminate this practice for publicly owned electric systems.

The Jacksonville (Florida) Electric Authority provides an example of the economic harm that the one-percent limit could cause. This publicly owned electric utility system participates in a joint venture with Florida Power & Light Company known as the St. Johns River Power Project. This project consists of two 600 megawatt coal-fired electric generating units. The joint venture with Florida Power & Light Company on the St. Johns River Project would not have been feasible had the one-percent limit be in effect. The Jacksonville Electric Authority estimates that its alternative of building one 600 megawatt coal fired unit with 100% JEA ownership would have resulted in increased costs of approximately $1.5 billion over the life of the plant.

The electric ratepayers of the small community of Braintree, Massachusetts would now be paying an estimated additional $50,000 per year if the one-percent limit had applied to the financing of Braintree Electric Light Department's 90 megawatt combined-cycle electric generator.

The one-percent limit, as it applies to public power, is also contrary to the proposals's stated objective of eliminating anti-competitive and distortive effects on the economy. Publicly owned electric utilities provide the major source of competition to the dominant, investor owned utilities in the electric power sector of the economy. Publicly owned utilities provide an effective benchmark against which to compare the performance of the much larger investor owned systems. The President's tax proposals would not impose new restrictions on investor owned utilities comparable to the one-percent limit.

Reducing the viability of publicly owned utility operations would reduce competition in the industry and foster the distorting effects of monopoly power. Such a result is intensified by other parts of the President's tax proposals which would appear to have the net effect of reducing the already strikingly small federal tax bill of investor owned electric utilities, and thereby enhance their economic power.

The goal of tax reform would not be served by applying the one-percent limit to public power bonds and other traditional public purpose tax-exempt financing. In the case of public power, the current 25 percent limit has proven sufficient to prevent abuses and at the same time allows the efficient construction and operation of facilities.

__Prohibition on Long-Term Management Contracts__

The proposal would not allow use of tax-exempt financing for facilities managed under contract by a nongovernment person for more than one year. A contract entered into by a municipal, or other publicly owned utility, with an investor-owned utility or other private party for a term in excess of a year, and which provides for the operation of jointly owned utility plant by the private party, would disqualify the investment made to purchase that plant with tax-exempt financing.

This prohibition ignores the fact that, in many instances, the investor-owned utility having a long-term contract to manage a jointly-owned project receives no additional profit from operating the facility, but merely collects from the joint owners their pro rata share of the actual costs of operation and maintenance. In addition, an investor-owned utility would refuse to make a sale of an ownership interest in a generating unit if it meant giving up the right to operate and manage that unit, particularly since in most instances, the investor-owned utility is the major owner of the unit.

Finally, very often municipalities and joint agencies will not have the expertise to operate, maintain, and manage the generating units in which they buy an interest. The prohibition on long-term management contracts would frustrate the ability of municipalities and joint agencies from supplying power in an efficient manner and lead to the costly requirement of duplicating manpower and knowledge already available and in place.

This proposed prohibition would severely hamper the joint ownership of electric facilities, and increase costs to electric consumers. In its application to publicly owned electric utilities, this restriction bears no relation to the professed goals of "fairness, growth, and simplicity."

## Restriction on Arbitrage

Under current law, publicly owned utilities are permitted to take advantage of arbitrage opportunities under specific, limited conditions. The revenues provided by arbitrage are used to reduce the costs of constructing energy facilities and thereby lower electric rates to consumers. The President's proposal would increase the financing costs of publicly-owned power suppliers by restricting their ability to earn legitimate arbitrage. It would require the rebate to the Treasury of all investment income earned in excess of the average coupon on a particular bond issue, with no allowance for the recovery of reasonable costs of issuance.

There is no practical point in making arbitrage rules so restrictive that the arbitrage earnings foregone simply result in larger sized bond issues at greater cost. It makes no sense to increase the volume, expense and complexity of bond issues when it is questionable whether there would be a net benefit to the Treasury. In its attempt to eliminate arbitrage abuses, the proposal would eliminate the arbitrage earnings necessary for efficient issuances.

In addition, the proposal ignores fundamental practicalities of financing long-term construction projects efficiently. Conventional power plants can take from 5 to 12 years to build, and it is inherently inefficient and totally unreasonably to--as the proposal would require--"spend a significant part of bond proceeds within one month" and "all bond proceeds within three years." Such a restriction would mean that bond issues for a long-term construction project would have to be issued on an almost monthly basis. This would be grossly inefficient and impractical in the case of a simple homebuilder, let alone the multi-million dollar, multi-year construction of a project as complex as an electric power plant.

Publicly owned utility financial managers would be limited in exercising their professional judgment in the structuring and timing of bond sales. The efficient size of a particular bond issue depends on factors such as the total cost of a project, the length of construction time, current and expected interest rates, issuance costs for various volumes, and other factors. Public power financial managers would be effectively precluded from considering these factors. Instead, they would be tied to arbitrary and unrealistic criteria of spending a significant amount of the proceeds over short time periods that have no relation to the size and construction schedules of projects.

## Prohibition of Advance Refunding

The proposed prohibition on advance refunding would severely restrict a publicly owned utility's ability to efficiently manage its debt--the way other enterprises do--to lower costs to consumers. The blanket prohibition of advance refundings would limit an issuer's ability to take advantage of lower interest rates, to restructure debt service to match a changing revenue stream, or to mitigate the effects of an overly restrictive bond indenture. In short, it would seriously impair an issuer's ability to exercise sound financial management.

For example, the Michigan Public Power Agency, a joint action agency of eighteen publicly owned electric utilities in Michigan, anticipates that it will soon be able to advance refund obligations issued to finance its 242 megawatt share of the 652 megawatt Belle River No. 1 coal-fired, generating unit. The anticipated refunding will result in an estimated $25.0 million saving for the agency and the electric ratepayers in its member communities.

Advance refundings do temporarily increase the volume of tax-exempt bonds outstanding, but they can also substantially contribute to an issuer's financial soundness. The attempt to reduce the volume of tax-exempt bonds by eliminating advance refunding undermines local government's right to issue tax-exempt bonds, and the basic economic benefits they derive from them. Taking away a publicly owned utility's ability to manage debt efficiently adds significantly to financing costs and strikes at the very heart of the right to use tax-exempt financing.

## Reporting Requirements

The proposal would extend to all tax-exempt bonds the IDB reporting requirements. Should issuers fail to file reports, the bonds would lose their tax exemption. This proposal would be both burdensome and unnecessary. A reporting requirement designed to police the issuance of private purpose industrial development bonds is totally inappropriate for public purpose obligations and is in no way related to the stated goal of tax reform.

## Prospective Application of Tax Code Changes

Based on statements of the Senate leadership, it is unlikely that a tax simplification bill will be enacted this year. At the same time, the President's proposed changes, if ultimately enacted, would be retroactive to January 1, 1986. In the interim, this could paralyze the capital markets because bond counsel will not issue "clean" opinions. Therefore, if any changes are made in public power's use of tax exempt financing, APPA strongly urges the committee to apply them only from the date of enactment and protect the tax exempt status of projects already underway.

## Conclusion

The American Public Power Association opposes the above described tax-exempt bond provisions of the President's May 1985 tax reform proposals. They go well beyond their stated goal of correcting abuses in the tax-exempt bond market, and attack the legitimate rights of State and local governments as issuers of tax-exempt bonds.

Taken together, these proposals would discourage efficiency in planning and implementing power supply programs, discriminate against one segment of the electric utility industry, reduce competition among power suppliers, and pose the prospect of higher electric rates throughout the country. All of this damage would be wreaked in the pursuit of a disproportionately small, theoretical revenue gain for the U.S. Treasury.

The American Public Power Association has long opposed the use of tax-exempt industrial revenue bonds for the primary benefit of private, profit-making entities. We would support changes to existing law that would eliminate such use of tax-exempt financing.

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**Statement By**

**Association of Local Housing Finance Agencies**

**to the**

**Senate Finance Committee**

**On The Impact of Tax Reform on Tax-Exempt Housing Bonds**

**September 24, 1985**

EDUCATIONAL CONFERENCE • NOVEMBER 6-8, 1985 • SAN FRANCISCO, CALIFORNIA

Mr. Chairman and Members of the Committee:

The Association of Local Housing Finance Agencies (ALHFA) appreciates this opportunity to present its views regarding the impact of tax reform on tax-exempt housing bonds.

ALHFA, which represents over 100 city and county agencies which issue tax-exempt bonds to promote affordable housing, was formed three years ago to provide local issuers the opportunity to share with each other and with Members of Congress the nature and variety of programs developed at the local level to meet the housing needs of our lower income citizens.

At the onset, ALHFA urges this Committee and the Congress to reject the President's proposals to eliminate the tax-exempt status of bonds for single family homeownership and multifamily rental housing.

Local government's ability to provide direct subsidies for housing those lower income people most in need has been effectively eliminated by the devastating budget cuts in the assisted housing programs over the last five years. The President's tax reform proposal would eliminate the only remaining tools. While we understand that Americans are being asked to accept their fair share of cuts in direct Federal assistance programs or tax incentives, local governments, and the public services which they're responsible for, are the only ones being forced to accept reductions in both. This is neither equitable, nor fair.

ALHFA's statement will highlight our concerns over the proposed elimination of both single family homeownership and multifamily rental housing bonds and suggest ways that the two programs might be improved.

In January of this year, the Department of Housing and Urban Development, at the direction of Secretary Pierce, conducted a study of the impact of the original Treasury tax reform proposal on housing. We were not surprised to hear that Secretary Pierce's staff concluded that rental housing opportunities for lower income persons would be seriously diminished, through a decline in the supply of rental housing over time and rent increases of 25 to 30 percent.

In order to determine for ourselves the full effect of the Administration's current tax reform proposals on the availability of affordable rental housing, a special study was prepared for the Fair Tax Policy for Housing Coalition, of which ALHFA is a member, by the Harvard/MIT Joint Center for Housing Studies and Wharton Econometric Forecasting Associates. That study confirmed what the HUD and other studies have found--that average rents would increase by 20 to 24 percent, that even modest rent increases would more than offset any gains lower income persons would get from the tax cut and that rental housing production would fall by an average of over 160,000 units per year. Much of this decline, approximately 25 to 30 percent of all rental units, would occur, according to this study, because of the loss of tax-exempt financed units by state and local agencies.

This last point is particularly critical for it means that the key role played by local housing finance agencies in identifying local housing needs and delivering housing assistance to low and moderate income households would be eliminated.

Although there are numerous elements of the tax reform proposal which affect rental housing, including the changes in depreciation, the rehabilitation tax credit, extension of the "at risk" rules to real estate and the limits on interest deductions by individuals, we urge the Committee to consider tax-exempt bonds as the element which interacts with all of these incentives and forces the only public policy consideration in their use.

Industrial development bonds have been issued by state and local governments since the 1930's, and have been used by local governments in stimulating economic development within the community. However, it was not until the late 1960's that the issuing of these bonds came under the scrutiny of Congress, due to the growing volume during that time period. In 1968, Congress amended Section 103 of the Internal Revenue Code to specify the purposes for which bonds could be used. One of those permissible purposes was the construction or rehabilitation of rental property.

That section of the Code was again amended in 1980 (and for homeownership bonds in 1981) to require targeting. Provisions were added specifying that the bond must meet a public purpose, i.e. 20 percent of the units in an IDB-financed project must be occupied by low and moderate income persons. This is the only form of IDBs which must meet a public purpose test. The definition of low and moderate income person was that which is used by HUD, under Section 8 of the Housing Act of 1937, i.e. 80 percent or less than the area median. The legislation further provided that when such a person first occupied a set aside unit, he or she would continue to be treated as income-eligible for as long as he/she occupied the unit, regardless of an increase in income.

' These provisions expressed Congressional concern that tax-exempt IDBs should be used only if they provided rental housing to low and moderate income persons, and that mixed-income developments were a desirable objective to achieve in this process. Thus, the use of IDBs in the context of housing has been regulated and restricted by Congress in order to assure that the potential revenue loss is offset by the gain to society of other beneficial purposes, namely the provision of affordable rental housing for low and moderate income persons.

It is important to stress the aspect of local control over the issuance of the IDBs for housing development within the community. Before any bond can be issued, a public hearing must be held on the proposed development at which members of the community express their views about the project. The chief elected official then must approve the project and counsel must certify that the issue will comply with all legal requirements. The scrutiny of local government, combined with the authority to turn down an application, gives the local government the option to impose additional conditions on the project which would meet some of the unique needs of the community that would otherwise go unmet.

Local housing agencies develop their programs according to their determination of local need and resources. They frequently go beyond the federal requirements in terms of "public purpose" and many are committed to exceeding it whenever possible.

A recent survey of ALHFA member agencies revealed some of the ways in which minimum public purpose requirements are being exceeded. We would like to share just a few of them with the Committee. These examples illustrate two points: many local housing finance agencies are going beyond the minimum public purpose requirements in targeting to lower income persons, although not required to do so; and minimum public purpose is being exceeded in a variety of ways, depending on what is feasible and will work based on conditions which exist locally.

o Fairfax County, Virginia requires that up to 25% of the units in an IDB-financed development be available to those with incomes no greater than 70% of median income, instead of the 80% median required by law.

o Anaheim and Oakland, California cap eligible income at 65% of the median income for the set aside units.

o Fairfield, California limits eligible income to 70% of the median figure.

o El Paso County and Boulder County, Colorado, require that the "set aside" units benefit households whose income does not exceed 50% of the median.

o Los Angeles, California, adjusts qualifying income downward from 80% of median for households with fewer than four persons.

o Bloomington, Minnesota sets aside 30% of the IDB-financed units for those with incomes below 80% of the median and also requires developers to contribute $500 per unit to a housing fund which provides funding to meet other lower income housing needs.

o The City of San Francisco, using IBD financing in conjunction with other federal and local funds, has completed rehabilitation of a vacant public housing project where 100% of the units are available to those at 80% or less than the median.

o Pittsburgh's Urban Redevelopment Authority, utilizing IDB financing, rehabilitated 251 previously HUD-owned buildings containing 333 units and an additional 13 buildings with 57 units and made 100% of the units available to low and moderate income tenants receiving Section 8 certificates. After these bonds have matured, the units will be converted to cooperative homeownership.

o Montgomery County, Maryland's Housing Opportunities Commission requires that 20% of units be for those at or below 65% of area median adjusted by family size; an additional 30% of units are limited to those between 65% and median income; rents for the set aside units are 30% of 65% income adjusted by bedroom size. If the acquisition is for rehab, the units must remain rental for 15 years.

o Several of our member agencies impose income limits on the other 80% of the units which are not required to be set aside for low income persons. The City of St. Paul requires that 55% of the units (beyond the 20% units) in an IDB-financed development be available for households with incomes between the 80 and 120% of median, as does the City of Santa Barbara, California.

o Brevard County, Florida, limtis income in the non-set aside units to those up to 150% of the area median.

o Santa Cruz, Sacramento, and Sonoma County, California, Housing Authorities as well as Santa Clara and Contra Costa Counties, also limit all or a portion of the set aside units to Section 8 Certificate holders "primarily those families whose income do not exceed 50% of median adjusted for family size).

o The City of Phoenix, Arizona has adopted a policy for IDB-financed developments which requires adjustment of median income by family size and requires developers to pay a participation fee of up to 1 point of the amount of the bond issue which is placed in a Rental Subsidy Program. This fee provides a subsidy for at least 25% of the set side units, for 10 years. The subsidy will reduce the tenant's portion of the rent to 30% of 65% of median including utilities.

o Pinellas County, Florida's Housing Finance Authority uses a point system in evaluating proposed projects prior to inducement, giving higher priority to projects setting aside more than the 20% of the units for low and moderate income persons and higher priority also to projects with 3 bedroom units for families with children.

o Broward County, Florida's Housing Finance Authority, in addition to prohibiting discrimination against children, imposes a rent cap on the set aside units and also requires a 2 bedroom set aside.

o The City of Dallas Housing Finance Corporation only undertakes IDB-financed projects in Community Development Block Grant target areas. Within those areas, priority is given to those projects serving the greatest number of low income persons. The City of Dallas also increases the 20% units set aside if the developer is projected to make too much profit. It will also forgive fees if the developer increases the number of set aside units. It also adjusts for family size and often requires that all set aside units be available to families with children.

o The Prince George's County, Maryland Housing Authority requires that in a targeted area, the plan must not only meet the 15% set aside requirement, but must also meet county rehabilitation requirements pertaining to energy conservation, and fire and safety code requirements. It further requires that the developer's plan provide for tenant displacement for Section 8 tenants through rent increase-phasing and project unit preservation agreements. It requires qualifying incomes to be adjusted for family size, and concentrates most of its IDB financing on the rehabilitation of older existing apartment projects.

The above cited examples clearly demonstrate that there is strict regulation at the local level over the issuance of rental housing bonds. We think it also demonstrates something further. Our agencies are committed to serving the housing needs of their citizens. They are committed to the responsibility of government support for those most in need and they are attempting to meet this responsibility in an ever more challenging environment.

The provision of affordable housing to low and moderate income persons is, we believe, without question, a public purpose. We see a public purpose in urban redevelopment and in the construction of new housing in blighted areas. We see a public purpose in providing mortgage assistance to struggling first-time homebuyers--those who because of high interest rates cannot afford conventional mortgages.

It seems unreasonable to use the guise of tax reform to try and steer local governments back into the public housing policies of the past. Under the President's plan, projects would have to be publicly owned to be eligible for tax-exempt bonds. The costs and inefficiencies of this method are immeasurable. When the private sector is willing to meet public purpose in exchange for a reduction in interest rates on their financing, we should be embracing the offer.

Clearly, the provision of rental housing assistance by direct subsidy at national level, not that this is a realistic option, would be less efficient and more expensive, not more efficient and less costly as the proponents of the Treasury plan have indicated.

The Wharton study concluded that the President's plan, although described as a proposal for fairness, growth and simplicity, will be neither fair, growth-inducing, nor simple. In fact, the apparent reductions in the federal tax liabilities of most people will be greatly overshadowed by "hidden taxes" which will derive by the operation of the proposed changes in the Internal Revenue Code.

__HIDDEN TAX OF RENT INCREASES__

o The study estimates that average rents would increase by 20 to 24 percent over no-tax reform levels by 1991. These findings document the conclusion reached by a broad consensus of housing economists that the Administration's proposal would increase market rents by discouraging the construction of new rental units, while increasing demand for rental housing.

o If rents increased by the 20-24 percent range projected in the study, only renter housholds with incomes higher than $50,000--or a very small fraction of American renter households--would reap tax savings under the Administration's Proposal in excess of their rent increase.

o Even modest rent increases would completely offset any advantage low-and-moderate income households may gain as a result of the proposed tax cuts. For example, a married couple renter household with two workers earning less than $25,000 a year could expect tax savings of less than $100 a year. By contrast, a rent increase of just 10 percent would cost this household an additional $350 to $600. Only renter households with annual incomes in excess of $30,000 would obtain tax savings in excess of even a modest 10 percent rent increase.

## THE HIDDEN TAX ON HOMEOWNERSHIP

O The study estimates that the Administration's proposed tax plan would increase the after-tax cost of homeownership by approximately 10-12 percent and make it even more difficult for young low-and-moderate income renter households to purchase a home. This conclusion is consistent with the broad consensus among housing economists that the Administration's Proposal would lower the value of owner-occupied housing.

o Even small changes in the price of housing could result in substantial reductions in the real value of homeowner equity. Much of this decline in equity would be borne by low-and-moderate income elderly and other long-term homeowners who have used their homes as their principal source of saving.

The increases in housing costs produced by the Administration's proposal would discourage investment in all types of housing, but especially rental housing for low-to-moderate income taxpayers. As a result, the quality of housing for many Americans would be reduced:

o The study projects that the Administration's proposal would raise the cost of capital for construction of rental units by an estimated 44 percent and thereby reduce investment in multiple unit housing structures (the prime source of new rental construction) by an average of 160,000 units per year, and cumulatively by 1,440,000 units by 1994.

o The proposed tax changes are projected to curtail investment in owner-occupied housing, reducing construction of total new housing units of all types (including multiple units) by an average of over 200,000 per year, and cumulatively by approximately 1,880,000 units by 1994.

o The construction of all rental units currently being financed at below market rates by State and Local Housing Finance Agencies--approximately 20 to 30 percent of all rental units--would be halted by the proposed changes in the tax treatment of investment in conventionally financed rental housing, the elimination of favorable tax treatment of investment in low-income rental housing, and the elimination of the tax-exempt status of industrial development bonds (IDB's). Furthermore, these proposed changes would sharply curtail, if not eliminate, the important role played by State and Local Housing Finance Agencies in identifying local housing needs and delivering housing assistance to low-and-moderate income households.

o Households would be required to adjust to the reduced supply and increased cost of housing by suffering a deterioration in housing quality. More Americans would be required to share housing or accept lower quality housing. The study projects that as a result of the Administration's proposal, an average of 150,000 fewer households would be formed each year, causing a cumulative reduction of approximately 1,340,000 households by 1994.

We would like to turn now to tax-exempt financing for single family homeownership.

Under the Mortgage Subsidy Bond Tax Act of 1980, state and local governments are permitted to issue bonds for homeownership subject to state by state volume limitations. There are also restrictions on program beneficiaries. They must be first-time homebuyers, the house must be their principal residence and it must be of moderate price. Twenty percent of the proceeds must be invested in targeted areas.

The 1980 Act contained a sunset date of December 31, 1983. During the last session, Congress extended that sunset until December 31, 1987. During consideration of the sunset issue, this Committee exhaustively reviewed the program's operation and benefits. Several reforms were ultimately adopted as part of the 1984 Tax Act. First, issuing agencies must develop policy statements describing program goals and methods for serving lower income people before those of higher income. Secondly, as a control, reporting requirements are now a part of every agency's program. Treasury is required to collect information on program beneficiaries and report the results to Congress in two years.

This Committee correctly decided last year that this program was meritorius in serving lower income, first-time homebuyers. It would be a tragedy to reverse this decision now simply because the Treasury has resurrected the same old fallacious arguments concerning these bonds.

Indeed, it is ironic that although this program serves those lowest on the potential homebuyer income scale, it is proposed for elimination while the mortgage interest deduction for existing homeowners remains intact under the President's plan.

A recent study by the Regional Planning Council in Baltimore, for example, showed that more than half of the families in any given Maryland County cannot afford an average priced new or existing home. The same situation exists in many parts of the Nation. The only hope for these people is through the issuance of tax-exempt bonds for homeownership.

RECOMMENDATIONS

ALHFA and its counterpart organization, the Council of State Housing Agencies (CSHA), have prepared a responsible legislative alternative to the President's proposed elimination of tax-exempt financing for low and moderate income housing. The full text of that alternative is attached to this statement. The following are its highlights.

1. require issuers of multifamily IDBs to prepare an annual policy statement (similar to that now required for MRBs) which identifies the housing needs of low and moderate income persons and details how tax-exempt financing will help to meet those needs.

2. require multifamily IDB issuers to have functional control of underwriting and enforcement activities.

3. codify in the Internal Revenue Code the requirement that multifamily IDB issuers adjuste incomes for family size and tie them to the number of bedrooms similar to the system used by HUD in the HoDAG program.

4. require multifamily IDB financed projects to meet one of the following income mixes: a) an 80/20 split with 20 percent of the units occupied by those at incomes of 70% or less than median. b) a 70/30 split with 30% of the units occupied at 80% of the median or less.

5. require that a proportional number of two or more bedroom units in the set aside units must be equal to or greater than the number of two or more bedroom units renting at market rate.

6. retain all of the current tax code incentives to stimulate the production of low and moderate income rental housing including preferential depreciation treatment, capital gains treatment, construction period interest, "at risk" exception and Section 167(k) qualified rehabilitation.

7. establish a national volume ceiling at $16 billion for each of 1986 and 1987 for the Mortgage Revenue Bond program, with annual adjustment thereafter tied to changes in the CPI.

8. reduce MRB average area purchase price limits in non-targeted areas to 90% for one and two bedroom units, 100% for 3 and 110% for 4 bedroom units, and in targeted areas to 110%.

9. codify in the statute Congressional intent language that

issuers of MRBs are expected, to the maximum extent feasible, to use their authority to assist lower income persons before higher income persons.

10. eliminate the December 31, 1987 sunset on the MRB program and make the program a permanent part of the tax code.

11. retain the Mortgage Credit Certificate program and amend it to reflect the statutory changes recommended herein for the MRB program.

12. allow issuers of single and multifamily bonds an increase of 25 basis points in arbitrage earnings which would be put in an issuer-administered trust fund to enable greater targeting of funds to lower income persons.

In conclusion, we would like to emphasize the need for this Committee to uphold our Nation's commitment for affordable, decent, safe housing for all of our citizens. The tax reform proposals clearly jeopardize this goal and should be rejected and the recommendations contained herein should be adopted.

# TAX REFORM LEGISLATIVE PROPOSAL FOR LOW- AND MODERATE-INCOME HOUSING

## MORTGAGE REVENUE BONDS MULTIFAMILY INDUSTRIAL DEVELOPMENT BONDS

Prepared by the Council of State Housing Agencies (CSHA)
and the Association of Local Housing Finance Agencies (ALHFA)

## PURPOSE

To provide Members of Congress with a responsible legislative alternative to the President's proposed elimination of tax-exempt financing for low- and moderate-income housing.

## OBJECTIVES

- To renew America's commitment for adequate and affordable housing for all Americans.
- To target state and local housing programs more directly so as to benefit low- and moderate-income families and individuals.
- To retain tax-exempt financing and other tax code incentives that are essential to housing production.
- To assist state and local governments in their expanding role as housing providers.
- To increase the overall effectiveness and efficiency of these programs.
- To ensure state and local compliance with federal requirements and standards by establishing monitoring procedures at all levels.

September 3, 1985

## PROPOSED CONTENTS OF LEGISLATION

## MORTGAGE REVENUE BONDS
## MULTIFAMILY INDUSTRIAL DEVELOPMENT BONDS

All statutory references are to the Internal Revenue Code unless otherwise noted.

## I. ISSUER RESPONSIBILITIES

### A. ANNUAL POLICY STATEMENT

Current Law: In order to issue tax-exempt Mortgage Revenue Bonds (MRBs), issuers must issue an annual statement of policy pursuant to Section 103A (j)5. No such requirement exists for the issuance of Multifamily Industrial Development bonds (Multifamily IDBs).

Proposal: An Annual Policy Statement similar to that required for MRBs would be required for Multifamily IDBs. It would be required to include language addressing the degree to which housing finance supported by the Multifamily IDBs would serve the housing needs of low- and moderate-income persons.

Rationale: Extending the policy statement requirement to all housing bonds would improve the targeting of program benefits and enhance federal government monitoring of bond issuers so as to ensure compliance with congressional intent.

### B. UNDERWRITING AND ENFORCEMENT STANDARDS

Current Law: None

Proposal: Statutory language would be developed to create minimum standards for issuers regarding functional control of underwriting and enforcement activities to establish state and local housing finance agencies as "ongoing concerns" with the primary objective of eliminating "paper" issuers.

Rationale: The new requirements would mandate that state and local governments follow sound underwriting practices, and monitor housing activity supported by tax-exempt bond financing to ensure that beneficiaries are being adequately served and to help eliminate potential abuses.

## I. SINGLE-FAMILY HOUSING (MRBs)

### A. STATE CEILINGS

Current Law: MRB state ceilings are presently based on the greater of $200.0 million or 9% of the 3-year rolling average of all statewide home mortgage originations.

Proposal: Establish a national volume ceiling of $16.0 billion for MRBs for years 1986 and 1987 with an annual inflation adjustment after two years. Initially, state ceilings would be based on a formula which combines per capita allotment with past levels of activity. It would also continue the $200 million floor for small states as well as the present formula for sub-state allocations. Additionally, a carry-forward provision, with a small percentage reduction penalty, would be included.

Rationale: Under the current formula, activity is rising significantly. The 1985 national ceiling is about $17.0 billion, 14.7% above the 1984 ceiling of $14.5 billion. The 1986 national ceiling for MRBs may climb above $21.0 billion. This goes beyond what is required to meet public purpose goals, particularly in light of the need to save revenues.

### B. PURCHASE PRICE LIMITS

Current Law: MRB-financed mortgages cannot be used to purchase homes costing more than 110% of the average area purchase price for new and old residences in non-targeted areas, and 120% of the average area purchase price for new and old residences in targeted areas (qualified census tracts and economically distressed areas).

Proposal: Reduce the 110% and 120% of average area purchase price safe harbors to 90% and 110% of the average area purchase price. Include a floor for low-income, primarily rural, areas based upon percent adjustments to the state average purchase price.

Rationale: The proposed changes would result in improved incomes targeting of MRB-financed mortgages. The proposal calls for a 20% reductions in non-targeted areas and a 10% reduction in targeted areas. The smaller adjustment for targeted areas will allow state and local governments to continue to address the special housing needs in economically distressed areas. Utilizing the state average purchase price as a floor in low-income market areas will allow states and local governments to continue to provide mortgage financing of new home construction in rural communities.

C. INCOME TARGETING

Current Law: Congressional intent language was added in the Tax Reform Act of 1984 to the effect that state and local issuers "are expected to use their authority to issue qualified mortgage bonds and mortgage credit certificates to the greatest extent feasible (taking into account prevailing interest rates and conditions in the housing market) to assist lower income families to afford home ownership before assisting higher income families."

Proposal: Codify congressional intent language on "lower before higher" to require that each state and local housing finance agency institute a "method" for accomplishing same. Examples, such as the following, would be included in report language: Colorado's prioritization of loan applications by income following a registration period; a set-aside of funds for low--income homebuyers; or a time period during which only households with incomes below a certain level could apply for an MRB-financed mortgage.

Rationale: This change would ensure that congressional intent was being met, while at the same time giving state and local government issuers adequate flexibility to address market conditions and needs in targeting MRB proceeds.

D. SUNSET

Current Law: Tax exemption for MRBs is scheduled to end on December 31, 1987.

Proposal: The MRB program would become a permanent part of the tax code.

Rationale: Regardless of the economic climate, there will always be a need to assist lower-income citizens attain their first home. With the improvements recommended herein, the MRB program presents itself as a valuable homeownership incentive for young Americans.

E. MORTGAGE CREDIT CERTIFICATES (MCCs)

MCCs would be retained and amended to reflect any statutory changes in the MRB program.

## III. MULTIFAMILY HOUSING (Multifamily IDBs)

### A. PROGRAM BENEFICIARIES

#### 1. FAMILY SIZE ADJUSTMENTS

Current Law: While no statutory provision is present in the Code, Treasury has given notice that it intends to issue regulations and require that HUD Section 8 family size adjustment factors be used for the low-income set-aside units.

Proposal: Language addressing family size adjustments should be codified. A more workable "unit-based" method for family size adjustments, similar to the one used by HUD in implementing the Housing Development Action Grant Program (HODAG),is recommended for IDB-financed rental projects in place of the HUD Section 8 family size requirements. Specifically, family size adjustments would be tied to unit size (based on number of bedrooms) in the following manner:

| Size of Family | Size of Unit | "Unit-Based" Income Limit |
|---|---|---|
| 1 person | efficiency | 56% median |
| 2 persons | 1 bedroom unit | 64% median |
| 4 persons | 2 bedroom unit | 80% median |

In addition, for larger bedroom units the family size would be adjusted upwards to allow income projections and rent levels to be based on a 6-person family for a three-bedroom unit and an 8-person family for a four-bedroom unit. Finally, family size adjustments in low-income, primarily rural areas would be based on the greater of the area median income or the state median income.

Rationale: There is a need to make permanent the concept of family size adjustments in the Internal Revenue Code. Their enactment will significantly improve the targeting of units towards lower-income individuals and large families.

The HUD Section 8 system of family size adjustments, designed for a deep rental assistance subsidy program, is wholly inappropriate for low-income units in IDB-financed projects. Under the Section 8 program, a one-person household pays the same rent whether it occupies an efficiency or a one-bedroom unit, a two-person household pays the same rent whether it occupies a one- or two-bedroom unit, and so on -- this is because the federal government pays the difference between the rent set for the unit and what the household can afford.

In contrast, in the absence of Section 8 subsidies, developers and underwriters of Multifamily IDB projects must be able to closely estimate rent levels by unit size in order to project revenues needed to cover debt service and operating costs. By tying family size adjustments to the size of the unit (number of bedrooms), developers will be able to establish rent levels for units of different sizes without having to predict in advance the size of households which will ultimately rent units in the project.

2. INCOME TARGETING

Current Law: Twenty percent of all units in a project must be rented to households with incomes below 80% of the area median income. The 20% requirement falls to 15% in targeted areas. (Also, while not in the law, Treasury has proposed adding family size adjustments to incomes which will reduce the income limits for 1-, 2- and 3-person households to 56%, 64% and 72% of area median income.)

Proposal: Create two separate programs which would require rental projects financed by Multifamily IDBs to meet one of the following income mixes: (1) an 80/20 split with 20% under 70% of median area income; or (2) a 70/30 split with 30% under 80% of median area income. There would be no income limitation on the market rate units.

Rationale: In order to reach low-income families and still maintain private sector involvement, a delicate balance must be reached. (Family size adjustments alone with mean 30% and 20% reductions in income eligibility, and therefore rents, for one- and two-person households.)

The flexible income targeting approach proposed above will make it possible to serve more low-income households because it is responsive to differences in incomes in local housing market. In urban areas, for example, because household incomes vary substantially, an IDB developer would likely choose to target its low-income units under option (1) above -- a smaller percentage of units, 20 percent, to households with incomes under 70% of area median income. This is because there would be higher income households in the area who could afford the higher priced market rate units and therefore make possible the lower rents paid by low-income tenants. In contrast, in many rural areas family incomes are relatively flat, therefore a developer might choose option (2) because the higher incomes needed to target incomes more deeply were not present in the market.

B. BEDROOM PROPORTIONALITY

Current Law: None

Proposal: Add a statutory requirement that a proportionate number of two or more bedroom units in the low-income set-aside units must be equal to or greater than the number of two or more bedrooms units renting at market rates. Limit bedroom proportionality to projects with more than 50 units.

Rationale: This would prevent a project owner from using only efficiencies and one bedroom units to meet the low-income set-aside requirements. When coupled with family size adjustment as proposed, these two requirements are significant incentives for the production of two and three bedroom units for low- and moderate-income families.

## IV. OTHER TAX INCENTIVES FOR MULTIFAMILY RENTAL HOUSING

Current Law: In order to stimulate real estate investment, Congress has enacted several tax code provisions which give favored treatment to real estate investors. These incentives include:

- Accelerated Cost Recovery System
- Capital Gains Treatment
- Construction Period Interest
- At Risk Exception
- Section 167(k), Qualified Rehabilitation

Proposal: Retain all of these tax code incentives for low- and moderate-income housing, including preferential depreciation treatment for the multifamily IDB product.

Rationale: Tax exemption alone is not a deep enough subsidy to allow for increased targeting and still retain private sector involvement. Multifamily rental housing is one of the least attractive real estate investments. The retention of these provisions would add value to investing in rental housing, thereby providing a further stimulus for construction.

## V. HOUSING TRUST FUND

Current Law: Arbitrage earnings are restricted to 1.125% for mortgage revenue bonds and 1.5% for multifamily IDBs.

Proposal: Allow bond issuers the option of increasing arbitrage earnings by 25 basis points. This increased amount would have to be used in the creation of a housing trust fund. Monies from the fund would then be used for the purpose of buying down low income mortgages or as direct rental subsidies for tenants in the low-income set-aside units.

Rationale: Many Members of Congress have expressed interest in having tax exempt multifamily housing bonds be targetted to the very low income as a replacement for lost direct federal subsidies. The housing trust fund tries to address that concern by establishing a mechanism whereby funds can be raised to target assistance to the needy.

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October 8, 1985

The Honorable Robert Packwood
Chairman, Committee on Finance
219 Senate Dirksen Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

On behalf of the Council of Industrial Development Bond Issuers (CIDBI), I am writing to share with you the findings of the first, comprehensive study of Small Issue Industrial Development Bonds (IDBs) for inclusion in the Committee's record on tax-exempt bonds. I strongly urge you and Members of the Finance Committee to review the results of this study as you evaluate pending tax reform proposals.

On June 25, 1985, I had an opportunity to testify at the Committee's initial hearing on tax-exempt bonds. At that hearing, there were a number of concerns voiced by Members of the Committee about Small Issue IDBs. Based on the facts and findings of CIDBI's completed study, I am better able to respond precisely to Members of the Committee, citing empirical nationwide data on the users, purchasers and issuers of Small Issue IDBs.

Let me pinpoint several of the major findings which respond specifically to questions raised at the June 25th hearing. I have enclosed for the Committee record the major findings of this study.

- o Small Issue IDBs are not used to support a bidding war among states for new industry. More than 75% of the 1,040 business surveyed used small issue financings to expand and modernize at the same site where they already operate a facility. An additional 20% used the financing to construct or renovate a different facility within the same state, leaving less than 5% of small issues supporting investments outside the firm's state of origin. Even this 5% figure overstates the frequency of interstate relocations of existing businesses, because a portion of these investments represent entirely new facilities in a different market region of the country. Therefore, in over 95% of the cases, Small Issue IDB financing are being used to stimulate new investment, not to engage in zero-sum games of interstate competition.

- Small Issue IDBs are being targeted predominantly to areas of higher than average unemployment. Across the country, more than two-thirds of the businesses surveyed undertook projects in areas experiencing unemployment rates at or above the national average.

- The overwhelming majority of Small Issue IDBs are used by small-to medium-sized business. Approximately 79% of the surveyed companies had sales of under $50 million. The survey also showed that elimination of small issue financings would increase annual borrowing costs to eligible small business projects by some 350 basis points.

- Small Issue IDBs have a negligible impact on the interest rates of other tax-exempt bonds since these financings are sold to a different market of investors. Unlike other categories of bonds where individuals purchasers dominate the market, approximately 90% of Small Issue IDBs by volume are purchased by commercial banks and other financial institutions. Because these financings provide a direct substitute for commercial loans and do not replace institutional investment in other categories of municipal bonds, the impact on other tax-exempt borrowers is minimal.

- Small Issue IDBs generate significant net new investment in the U.S. economy. In the most conservative estimate, at least 22% of the aggregate Small Issue IDB-supported investment is net new investment. In other words, if SIDBs were eliminated, nearly one-fourth of the SIDB-financed expansion would have been delayed or cancelled.

- Finally, the net revenue losses associated with Small Issue IDBs have been consistently overstated because estimators have not had an opportunity to use empirical data to calculate more accurately the costs of these financings. This study, for the first time, will permit Treasury and Congressional estimates to be based on specific information about the proportion of Small Issue IDBs held by financial institutions and the internal portfolio substitution that occurs when Small Issue IDBs are not available. Combining this information with the methods by which banks interest income is taxed, use of the Treasury model to calculate revenue losses produces a very different result. The actual revenue impact of Small Issue IDBs upon the Treasury is neutral to slightly positive.

Mr. Chairman, these findings will substantially add to available information about Small Issue IDBs. I am confident this study and its findings will assist your efforts in thoroughly reviewing the benefits and "true" costs of this important economic development financing program.

The Honorable Robert Packwood
October 8, 1985
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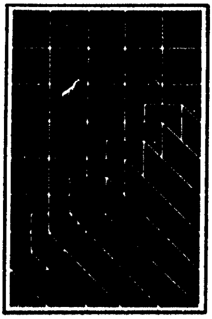
Finally, Mr. Chairman, at the June 25th hearing you requested my recommendations regarding further changes to Small Issue IDBs. CIDBI's membership has subsequently endorsed a reform proposal calling for targeting of these financing to areas in need and to small businesses. This proposal, I should note, is based on our review of the study information and our discussions with you and other Members of Congress about the need for further changes in the program.

CIDBI is prepared to work with you and the Committee as you develop legislation affecting Small Issue IDBs.

Sincerely,

James J. Hughes Jr

James J. Hughes, Jr.
President



# Major Findings

# Small Issue Industrial Development Bonds

and the

# U. S. Economy

prepared by

Developing Systems Limited Consortium

Washington, D.C.

for the

Council of Industrial Development Bonds Issuers

September 1985

## ABOUT THE STUDY

What follows is drawn from the study of "Small Issue Industrial Development Bonds and the U.S. Economy," undertaken by Developing Systems, Limited, and its Consortium of associated firms: Arthur Young and Company; Larry Eastland Associates; and Rose, Schmidt, Chapman, Duff & Hasley. In addition, Evans Economics, Inc. was contracted to carry out macroeconomic analysis. The study was undertaken from May to September 1985, for the Council of Industrial Development Bond Issuers.

The principal authors and participants in the design and execution of the study include: Dr. Arthur Domike, Dr. Ronald Muller, Dr. Nancy Barrett, William Castner, Joseph Holtzman, Dr. Jeffrey Colvin, and Thomas Megan of DSL; Dr. Gary Clyde Hufbauer, James Hostetler, Milan Miskovsky and Kathy Matthews of Rose, Schmidt, Chapman, Duff & Hasley; Dr. Larry Eastland of Eastland Associates and Neil Tierney of Arthur Young & Company.

# Major Findings
# of
# Small Issue IDBs And The U.S. Economy

## Legislative History

Congress authorized Small Issue Industrial Development Bonds (SIDBs) in 1968, by targeting the use of tax-exempt finance for local economic development to private sector investments of less than $5 million (since raised to $10 million). This incentive was intended to stimulate job creation, improved productivity and tax revenues through expanded economic activity, with preference to smaller businesses.

Tax law changes in 1982 and 1984 further strengthened SIDB user preference towards small business while prohibiting certain types of projects and placing a volume "cap" on IDB issuance by individual states. Sunsets were legislated for non-manufacturing SIDBs at the end of 1986 and for manufacturing projects at the end of 1988. Tax simplification proposals currently pending before Congress would terminate SIDBs and all private activity bonds next year.[1]

## The SIDB Controversy And The Information Gap

Throughout this legislative history there has been a heated debate about the impacts of IDBs in general and SIDBs in particular upon economic growth and the Federal Treasury. This "numbers war" has been fueled by lack of a broad base of empirical data to test the conflicting assumptions of both opponents and proponents of SIDBs.

In light of these developments, the Council of Industrial Development Bond Issuers (CIDBI)[2] -- formed in 1984 by the principal state and local agencies engaged in SIDB issuance -- sponsored the first, large-scale empirical evaluation of the impact of the bonds on business, employment and the economy. It was CIDBI's belief that solid and timely evidence was needed regarding:

- What kinds of businesses benefit from the bonds?
- Who buys Small Issue IDBs?
- For what purposes are they issued?

Only with answers to these questions based on actual empirical data is it possible to address with some degree of confidence the central concerns of Congress, including:

- What are the impacts of SIDBs on federal revenues and the deficit?
- What would be the consequences to the economy if SIDBs were eliminated?
- Are state and local development agencies through their issuance of SIDBs contributing effectively to the achievement of national policy objectives of full employment, stable growth and international competitiveness?

The objective of this study is, thus, to provide Congress, the Administration and state and local authorities with evidence and analysis needed to make sound decisions on the future of SIDBs.

## Study Methodology: Filling The Information Gap

CIDBI commissioned an independent research group headed by Developing Systems, Limited (DSL)[3] of Washington, D.C. to prepare an in-depth analysis of the impacts of SIDBs. To carry out this mandate:

- 1040 businesses were interviewed in a randomly sampled national survey of SIDB recipients;
- Interviews were conducted with SIDB issuing agencies in forty states and with over 50 institutional purchasers of SIDBs;
- Econometric analyses of the macroeconomic impacts of SIDBs were performed; and
- Congressional hearings and records plus studies prepared by state and local development agencies and academic institutions were thoroughly analyzed.

Data from this effort provides the first complete picture of the interrelationships among issuers, users, and purchasers of SIDBs. This study has produced statistically reliable data that can be incorporated into the various estimation models used by the U.S. Treasury, Congressional Budget Office and others to calculate the costs and benefits of tax-exempt investment.

## Profile Of Typical SIDB Borrower[4]

Only if one knows the characteristics of the typical user is it possible to determine what the federal revenue and other impacts of SIDBs are. Heretofore, the empirical basis has been lacking for establishing a profile of the typical SIDB borrower. Now, from the 1040 businesses surveyed by this study, a picture emerges of the "average" business and project receiving SIDB financing:

- A 25 year-old small business (about $5.5 million sales in 1984) obtains a $1.6 million SIDB with a 15-year maturity to help finance construction of facilities and new equipment at an existing site of the company.

- If the SIDB had not been available, the company would have reduced its investment by about one-third, or would have delayed the project for a year or more.

- Some 25 new jobs are created by the project, with a median annual wage of $19,000 -- for a total addition to company payroll of $475,000 annually.

- These new jobs are more likely to be located in a geographic area with unemployment at or above the national average.

- Total cost of the project is about $2.1 million, and the loan collateral is the business property itself.

- The company has a 25-30% effective tax rate and paid about $25,000 in federal taxes in 1984.

- The rest of the project finance -- about $500,000 -- comes from retained earnings and/or a commercial loan.

- Interest savings from the SIDB (of some 350 basis points annually) are being dedicated primarily to future development of the business: more plant expansion, working capital, and marketing.

- The purchaser of the SIDB is the local bank with whom the company had already been doing business.

## Central Findings

The central findings from the data gathering and analysis may be summarized as follows:

1. ABOUT 78 PERCENT OF THE USERS OF SIDBs ARE SMALL TO MEDIUM-SIZED BUSINESSES (LESS THAN $50 MILLION IN ANNUAL SALES).

   Small and medium size businesses received 69% of the value of all SIDBs and 78% of the total number of financings. State and local issuers have targeted these businesses recognizing the role of smaller businesses as a major source of this nation's growth in employment and productivity. Barriers to eligibility of larger firms created by the 1984 tax law changes should further increase the SIDB program's future orientation to smaller businesses.

2. SIDBs HELP OVERCOME THE LONG RECOGNIZED "SMALL BUSINESS CAPITAL GAP" BY DIRECTLY SUPPORTING 8 - 10% OF ALL INVESTMENT IN PLANT AND EQUIPMENT BY THIS SECTOR.

   Small business users of SIDBs face a capital gap, but not because they are marginal companies. Over 75 percent of the bankers sampled reported that firms receiving SIDBs have lower default rates than those receiving conventional financing.

SIDB elimination would increase annual borrowing costs to eligible small business projects by some 350 basis points. More small business SIDB users would reduce, delay, or cancel their expansion projects without this financing. Since smaller companies are also more dependent than larger companies upon debt for expansion capital, total investment in the most dynamic job-generating sector of the economy would be reduced disproportionately.

Studies by the Federal Reserve and others have documented that smaller banks are the most important source for overcoming the small business capital gap. This survey demonstrates that SIDBs are placed proportionately more often with small banks to stimulate investments by local small and medium sized businesses. The survey further showed that bankers place customer relations ahead of tax exemption among the reasons for investing in SIDBs.

3. THE EFFECTS OF NEW SIDB ISSUES ON THE INTEREST RATES OF OTHER TAX EXEMPT BONDS IS MINIMAL BECAUSE THE VAST MAJORITY OF SIDBs ARE SOLD IN A DIFFERENT MARKET.

Fears that SIDBs will "crowd out" traditional state and local borrowing are not sustained by the evidence. The overall market for tax-exempt bonds is dominated by private individuals. In contrast to SIDBs, other types of new tax-exempt issues are purchased overwhelmingly -- up to 81 percent -- by private individuals.

In contrast, the survey found that over 75% of SIDBs are bought by commercial banks and S&Ls. Banks hold virtually all of these bonds to maturity. Only 18 percent of the banks surveyed ever sold any of their SIDBs from their portfolios in a secondary market. As a result, new issues of SIDBs generally do not compete with other tax-exempt instruments for loanable funds.

It should also be noted that the relative importance of SIDBs to total state and local tax-exempt debt fell from 24.1 percent in 1981 to 15.1 percent in 1984.

Studies have shown that the interest rate effect of tax-exempt instruments may be less than 2 basis points for every $1 billion of bonds issued. Since our surveys indicate that only 20-30 percent of SIDBs compete in the same markets with other tax-exempts, the total 1984 SIDB volume would increase rates by 10 basis points.

4. FEDERAL REVENUE LOSSES ASSOCIATED WITH SMALL ISSUE IDBs HAVE BEEN PERSISTENTLY OVERSTATED IN PAST ESTIMATIONS. USING CONSERVATIVE ASSUMPTIONS, ELIMINATION OF SIDBs WOULD HAVE A

NEGLIGIBLE IMPACT UPON THE FEDERAL DEFICIT: USING MORE REALISTIC ASSUMPTIONS, ELIMINATING SIDBs WOULD CAUSE FEDERAL REVENUES TO SHRINK.

In the most conservative case, revenue losses from SIDB issuances are small, substan~~tially bel~~ow the estimates published by the Treasury Department. In the more realistic estimation based on bond-holder data collected for this ~~study, revenue~~ gains slightly exceed losses. If account is taken of either the "revenue reflows" or the "additionality" effects, revenue gains will balance losses for the conservative case and appreciably increase gains to the federal government in the more likely case.

A "numbers war" over the impact of SIDBs on federal revenue has been caused by the lack of an adequate empirical basis for estimating the tax rates of bond holders and borrowers, and the costs of alternative sources of capital to the SIDB borrower. This confusion has been further exacerbated by lumping SIDBs together with the effects of all tax-exempt bonds instead of analyzing SIDBs separately to take account of the significant difference in who uses and buys SIDBs compared with all other tax-exempts.

Over 75% of the SIDBs were purchased by commercial banks whose effective tax rates are substantially lower than rates paid by individual buyers who dominate the market for other types of tax exempt bonds. When these values are inserted into the Treasury's revenue projection model, the net effect on federal revenues is slightly positive.

If revenue reflows are considered, the effect on federal revenues is decidedly positive. If SIDBs were eliminated, analyses conducted by Evans Economics show that the rates of economic growth and of capital formation would both fall. Econometric analyses show a cumulative decrease in GNP of over $3 billion for every $10 billion reduction in SIDBs. Assuming that the economy will be operating at less than full employment over the 1986-90 period, the analysis indicates that the federal deficit would increase by $2.9 billion if projected volume for the period, as given by Treasury, were to be eliminated; this calculation is based on simulations showing a $1.2 billion decline in tax revenues for every $10 billion of SIDBs that were not issued.

Even if revenue reflows are ignored, the survey clearly demonstrates the existence of additionality -- that is, increased tax revenues from investments that would not have taken place without SIDBs. Based on actual empirical findings, it may be conservatively estimated that the investment represented by 22% of all SIDB issues would not have gone forward or would have been significantly delayed if SIDB financing were not available. Even if one assumed only 10 percent additionality, approximately $278 million in added federal tax revenues is being generated for every ten billion dollars of SIDBs issued.

5. STATE AND LOCAL GOVERNMENTS ARE RELYING INCREASINGLY ON SIDBs TO ATTAIN ECONOMIC DEVELOPMENT OBJECTIVES BECAUSE SIDBs RESPOND TO LOCAL DEVELOPMENT PRIORITIES AND OFFSET CUTBACKS IN FEDERAL ASSISTANCE PROGRAMS.

   Issuers have been targeting SIDB financing to areas of higher unemployment and stimulating new economic activity. Local officials regard this incentive as their most effective economic development tool.

   Nearly two-thirds of the SIDBs have been used in areas with unemployment rates of 7.3% or higher. This survey revealed that a relatively large number of businesses investing in distressed areas would have had to cut back or postpone indefinitely their projects without SIDB financing, compared to the nationwide sample of all such investments.

6. A SIGNIFICANT PORTION OF ALL SIDBs DIRECTLY INCREASE THE PRODUCTIVITY AND INTERNATIONAL COMPETITIVENESS OF U.S. INDUSTRY.

   Small Issue IDBs are being used to upgrade productivity and efficiency in those manufacturing industries with the most serious productivity lags. Manufacturing industries in which labor productivity has been dropping at the rate of one percent or more per year have received over 40 percent of SIDBs provided to the manufacturing sector.

   Over 40 percent of all SIDB users are engaged directly in, or affected by, export trade; and virtually all these recipients used their SIDB financing for trade related projects. Two-thirds of these trade impacted projects are in the manufacturing sector. In fact, more than half of all manufacturing SIDB projects produce some portion of their output for export.

7. ISSUERS RARELY USE SIDBs TO FINANCE INTERSTATE RELOCATIONS FROM ONE LABOR MARKET TO ANOTHER.

   Only 5% of all SIDB projects involve any sort of investment by a firm across state lines and much of that entails expansion into new market regions. Moreover, almost 75% of all SIDB financings support expansions or improvements at sites previously operated by the beneficiary.

## Summary Conclusion

THE VAST MAJORITY OF SIDBs ARE BEING USED IN A MANNER THAT IS CONSISTENT WITH CONGRESSIONAL INTENT AND OTHER IMPORTANT FEDERAL POLICY GOALS. While these findings point to possible areas for further reform and improvement, Small Issue IDBs are clearly responding to significant national policy objectives while meeting basic state and local economic development needs. Moreover, many states and localities have instituted more restrictive and targeted SIDB requirements that go beyond what current federal law requires. SIDBs are being directed to revitalize areas of high unemployment, to overcome the small business capital gap, and to meet other priority economic development objectives. Further improvements, if carefully designed and making full use of available empirical information, could enhance the substantial benefits that SIDBs provide to the nation's economic growth and fiscal well-being.

## FOOTNOTES

[1] The Administration proposal defines Private Activity, or "non-governmental", Bonds as any tax-exempt financing in which more than 1% of the proceeds goes to the benefit of a private party.

[2] The Council of IDB Issuers is comprised of 117 member agencies nationwide, responsible for almost half of all SIDBs issued during 1984.

[3] The firms associated in this study with Developing Systems Limited include Arthur Young & Company, New York; Larry Eastland Associates, McLean, Virginia; and Rose, Schmidt, Chapman, Duff and Hasley, Washington, D.C. Members of the DSL study team included a former Research Director for the Congressional Budget Office and a former Deputy Assistant Secretary of the U.S. Treasury Department. In addition, Evans Economics of Washington, D.C. was contracted to prepare estimates of macroeconomic impacts.

[4] The composite typical financing is derived from the survey of 1040 SIDB borrowers and represents either the statistical mean of the data collected, or the response provided in over half the cases.

# TESTIMONY OF GARY W. SMITH

Executive Director
CHESTER COUNTY DEVELOPMENT COUNCIL
CHESTER COUNTY INDUSTRIAL DEVELOPMENT AUTHORITY
Chester County, Pennsylvania

to the

SENATE COMMITTEE ON FINANCE

regarding

PROPOSED INDUSTRIAL DEVELOPMENT BOND LEGISLATION

September 24, 1985

CHAIRMAN BOB PACKWOOD AND MEMBERS OF THE SENATE COMMITTEE ON FINANCE:

My name is Gary W. Smith and I am the Executive Director of the Chester County Development Council as well as the Industrial Development Authority for Chester County, Pennsylvania. Chester County is within the Philadelphia SMSA and has a population base of 325,000 residents. We are a growing suburban county in the Delaware Valley and represent a significant diversified business base which has been growing primarily due to the availability of the Industrial Revenue Bond and Mortgage financing program.

The Chester County Development Council, created in 1960, is a private, non-profit industrial development corporation which has a membership of over 400 corporations within the county which I represent. Through technical and financial assistance, the Council encourages and assists new businesses to locate in Chester County, thereby stabilizing employment by diversification. Acting as a clearinghouse for business data, the Council provides information on available industrial land and buildings, zoning regulations, wage rates, population statistics, tax rates, trucking data, etc. It also supplies guidance and assistance to local organizations with similar objectives.

The Chester County Industrial Development Authority (CCIDA) is a municipal authority created by the County of Chester to arrange low cost financing to enable commercial and industrial enterprises to economically justify their corporate investment. The Authority's primary objective is to stimulate the county's economy by attraction of a diversification of business development geared toward the reduction of Chester County's unemployment and building upon and solidifying the municipalities' tax base. Two basic parameters are taken into consideration by the CCIDA in evaluating the potential of a prospective capital development project---the economic fruits to be harvested as a result of the project's success, and the financial capabilities of the applicant to service his debt adequately.

My primary function is one of economic development promotion and assistance to firms who are interested in either relocating or expanding within Chester County. The main objective of the organizations that I represent is to promote long range, county-wide industrial growth to provide additional job opportunities for present and anticipated resident workers. In addition, the Development Council seeks to promote and advance the interest of all other related commercial activities to enhance property ownership and capital investments.

By far the most potent and powerful economic development tool to which we have access is the Pennsylvania Industrial Revenue Bond and Mortgage Financing Program. Our Industrial Development Authority averaged $150,000,000 in financing during the past three (3) years with the creation per year of over 5,000 jobs within Chester County during the next three years. Our three year mean has been 110 businesses being assisted in various stages of either creating or improving a yearly average of 3 million square feet of industrial and commercial space within our county borders.

On May 31, 1985, President Reagan visited our county and proclaimed us as the "Silicon Valley of the East". When the President visited Great Valley Corporate Center in Malvern, Chester County, his staff was informed that the business center consists of 6,000 employees in 34 buildings. It should be noted that 1500 employees and 18 buildings totaling over 600,000 square feet in the park were established using the cost-effective IRB financing program.

On behalf of Chester County's Development Council and Industrial Development Authority, the economic development agencies for Chester County, we urge you to vote against any industrial revenue bond or mortgage (IRB) restrictions that would lessen the effectiveness of this most important job-producing and revenue raising inducement financing program that this country has available to encourage business development. As you are aware, the IRB program was severely pruned in 1983 with the body enactment of the Tax Equity and Fiscal Responsibility Act which imposed serious restrictions and additional regulations. Additional restrictions were imposed by the Tax Deficit Reduction Act of 1984 with the state per capita limitations. However, we have regulated our pace of activities and have prudently managed our limited funds to discover that Chester County is the only Philadelphia suburban county who still has an allocation left at this date.

It becomes quite evident, therefore, that industrial revenue bonds are a vital economic development tool for Chester County's economic well-being. Independent studies have shown this financing program is very cost effective in bringing additional revenues to municipalities. More importantly, IRB jobs are not temporary but instead are permanent additions to the tax base. A recent independent study was conducted in the State of New York on a volume of $100,000,000 of IRB's that were issued and it was determined that an 8:1 benefits-to-cost ratio analysis was generated. Furthermore, the Treasury Department has forecasted revenue in the amount of $14 billion could be realized if this program is eliminated. The statistic is very short-sighted due to the faulty speculation that all projects that were funded in 1984 would be developed without the assistance of this program. The Public Securities Association (PSA) have commissioned an independent study done by Coopers & Lybrand, one of the nation's top accounting firms, which revealed that in essence only $2 billion would be realized by the U.S. Treasury without the program and thousands of jobs and additional tax revenues would be sacrificed.

Because of the unemployment problems we are experiencing, I feel that crippling the IRB program, the most efficient job-creation program available, is unwarranted and ill-advised. We would ask for your vigilant support to stand against any opposition that the critics of this program are trying to artificially fabricate.

The Chester County Development Council and Chester County Industrial Development Authority have adopted the following resolution urging the United States Congress to enact no legislation to tax or restrict the continued issuance of tax-exempt obligations by state and local governments:

WHEREAS, the counties, cities, boroughs and townships of Pennsylvania finance capital projects for various purposes defined by state law through the issuance of obligations whose interest is exempt from Federal income taxation;

WHEREAS, The projects financed with said obligations provide for the benefit of all area citizens through increased employment and capital investment which result in additional Federal tax revenues;

WHEREAS, Certain proposals being considered by the United States Congress would severely restrict the ability of states and localities to issue such obligations as defined by duly enacted state statute;

WHEREAS, Certain proposals being considered by the United States Congress would subject the interest earned on said obligations to Federal income taxation, or eliminate the ability of financial sources to deduct the cost incurred in buying and carrying tax-exempt obligations, and would adversely affect economic development job creation and capital investment by the private sector;

NOW, THEREFORE BE IT RESOLVED, that the Chester County Development Council and Chester County Industrial Development Authority urge the United States Congress to enact no legislation which would further limit the ability of state and local governments to issue tax-exempt obligations as defined by duly enacted state law, tax the interest on said obligation or eliminate further the ability of financial sources to deduct the costs of purchasing or carrying such obligations, and also urge the United States Congress to amend the Tax Code to eliminate the 1986 sunset for non-manufacturing Industrial Development Bonds and the 1988 sunset for all Industrial Development Bonds.

It is indeed a pleasure to have the honor to communicate to you my concerns on the IRB legislation and I trust that I have offered some mearingful comments to assist you in developing a prudent and equitable solution to this situation.

**Paul W. Muller**
**Public Finance Specialist, Kirchner Moore & Company**
**Denver, Colorado**

**Statement Submitted to**
**Committee on Finance**
**United States Senate**

## Senate Testimony

My name is Paul W. Muller. I am a Public Finance Specialist in the Public Finance Department of Kirchner Moore & Company. Kirchner Moore was founded in 1961 in Denver, Colorado. We serve as investment bankers for public entities throughout the United States. I would like to address several issues in my testimony today. The format of my presentation will be to concentrate on the most commonly asked questions regarding the advanced refunding of public purpose tax-exempt debt.

The President's proposal for tax reform includes two sections which would eliminate the advance refunding of public purpose tax-exempt debt. Those sections are 11.01 and 11.02. Advanced refunding of public purpose tax-exempt debt is the only financial tool available to municipal entities and school districts fcr debt restructuring.

## What is an Advanced Refunding?

A refunding is simply a refinancing of all debt. In municipal finance, this is accomplished by issuing new (refunding) bonds and using the proceeds to pay off the old bonds.

An advanced refunding is a special type of refinancing of old debt. Instead of immediately paying off the old bonds, the proceeds from the sale of the new (refunding) bonds are used to buy United State Government Bonds, which are then placed in an escrow fund, and payments from these United States Government Bonds are used to pay principal and interest on the old municipal bonds. It is important to note that only "public purpose" debt can be advance refunded. One cannot refund an industrial development bond. Due to these already existing restrictions it is clear that advance refunding is, in and of itself, a public purpose activity.

## Why Would a Municipality Do an Advance Refunding in the First Place?

1. Improved Financial Condition: to reduce taxes or rate payer fees. Typically, municipalities must promise bond holders to levy taxes or charge sewer or water rates in amounts greater than bond debt service requirements. This promise is called a "rate" or "tax" covenant. A municipality, like a business, does not collect 100% of its taxes or fees on a timely basis, so the amount of excess taxes or fees required by investors for security depends on the "track record" of a particular municipality in generating sufficient revenue to service its debt. As a well-managed municipality develops a successful "track record," it can substantially reduce its tax or rate covenant requirements, if it can advance refund its old bonds to eliminate old high tax rate covenants. Elimination of advance refundings will unnecessarily require maintenance of higher taxes and user fees by well managed municipalities.

2. Reduce Interest Costs: to reduce taxes or rate payer fees. Virtually all municipalities are limited by state laws concerning the amount of taxes they can levy. When interest rates decline, well managed municipalities take advantage of lower rates to issue new lower rate refunding bonds, usually with longer maturities, which have the overall effect of reducing the annual bond debt service and thus reducing taxes necessary to service those bonds. Were it not for advance refunding, municipalities would be locked into high interest rates even when lower rates are prevalent in the marketplace and available to all other capital market participants. As noted earlier, Treasury regulations already prohibit any municipality from profiting on the purchase of United States Government bonds to pay off the old municipal bonds. In other words, advance refunding of tax-exempt debt cannot be an "arbitrage motivated" or "arbitrage driven" transaction.

3. Manage Cash Flow Deficiencies. From time to time, even the best-run states and municipalities encounter financial problems, often due to economic considerations beyond their control. Many times it takes several years to work out these problems. Through advance refundings these municipalities can "stretch out" maturing bond principal when market conditions are most favorable. Without advance refundings, municipalities would be forced to borrow only at the time old bonds mature and accept the then current interest rates, no matter how high they may be. Moreover, advance refundings permit such municipalities to eliminate restrictive covenants which might otherwise result in a municipal default.

4. Remove Restrictive Debt Covenants. Often times municipal entities need to remove overly restrictive debt covenants from prior bond issues. By advance refunding oustanding debt, entities legally defease these issues allowing them to structure new bonds with debt covenants that are more suitable to the entity.

## Do Municipalities Make Arbitrage Profits from Advance Refundings?

Municipalities are not permitted to make arbitrage profits in advance refundings. Present regulations require that the interest on United States Government Bonds purchased by the municipality for the refunding escrows may not exceed the effective interest rate on the new refunding bonds. This effectively eliminates any arbitrage motivation for conducting advance refunding transaction.

## Can Municipalities Issue Debt With a Shorter Call Protection Period?

Usually the old municipal bonds being refunded cannot be paid off immediately, because the municipality has promised that it will not prepay the old bonds for a specific period, typically 10 years. This requirement has been necessary for many years to induce investors to buy municipal bonds in order to assure them that the bonds will not be redeemed the first time the interest rates drop from the level provided for in the bonds.

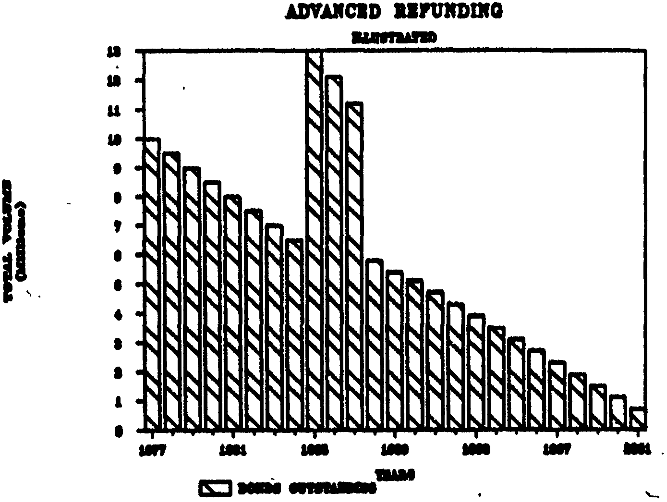
The technical term for this promise made by municipalities to the purchaser of municipal bonds is "call protection." It is interesting to note that on the United States Government Bonds, the call protection period to insure marketability is 24 years. With municipals, call protection is usually limited to 10 years.

Does Advance Refunding Really Double the Volume of Debt as Treasury Asserts?

Moreover, it is also important to note that the staff of the Treasury Department argues in the President's proposal that advanced refunding doubles the volume of tax-exempt debt associated with a given project. This assertion is wrong. In most refundings, those bonds that are callable are called at the earliest possible call date which, as a result, effectively reduces the volume of debt outstanding with a given project. Furthermore, municipal debt is usually serial. This means that debt is paid off over a period of years as opposed to all in one lump sum such as a balloon payment. A graphic description o. this situation is below.

Assumptions: Original Bonds Issued 1977
Par Amount - $10 million
Matures 2001, Callable 12/31/87

Refunding Bonds Issued 12/31/84
Par Amount - $7 million
Matures 2001



The graph depicts the following situation. In 1983 this sample bond which was issued in 1977 had $7.5 million of remaining principal to be paid. At the end of 1984, the sample bond was refunded causing a near doubling of the dollar volume of the bonds outstanding in 1985, for a one year period. The original bond issue, like the majority of municipal bonds, is serial i.e., it is paid off over a number of years as opposed to being paid off in one large lump, a balloon payment.

At the end of 1987, the bonds remaining in the original issue are called (redeemed) since calls are now allowed. Hence, at no time does an advance refunding cause the volume of tax-exempt debt to increase to an amount twice the original volume ($20 million) associated with building, for example, a school house. Morevover, three years after the refunding has taken place, the volume of tax-exempt debt is actually less than half the original issue since the original bonds were called.

## Does Advance Refunding "Cost" the Federal Government a Lot of Money?

The revenue loss associated with advance refundings is minimal. The figures that the Treasury Department included in the President's tax plan indicate that arbitrage revenue loss on tax-exempt bonds is less than $100 million in 1986, $209 million in 1987 and $191 million in 1988. Moreover, this figure includes all arbitrage associated with tax-exempt finance. The loss associated specifically with advance refunding would be less than the total figure.

Furthermore, the Treasury has not added back into these figures the value of the below-market-rate U.S. Government bonds that it sells to municipalities for use in their escrows which service the old bond issue.

In fact, from March 1980 to February 1985 the U.S. Treasury deficit financing costs were reduced by over $5 billion (approximately $1 billion per year) due to advance refundings according to a study by the First Boston Corporation. These cost savings were produced by the sale of lower yielding, non-marketable state and local government series securities (SLGS) purchased by tax-exempt entities to facilitiate advance refundings. From March 1980 - February 1985 the average rate spreads between SLGS and marketable government securities ranged from 2.28% (March 84 - February 85) to 5.20% (March 81 - February 82).

The average spread for the 5 year sample period was 3.43%. Therefore, even using the most conservative historical annual spread of 2.28% the cumulative savings 1986 - 1990 would be as follows:

| SLGS Issued Year | Estimated Volume of SLGS (in billions) | Estimated Spread | Annual Revenue Generated (in billions) | 1986 - 1990 Cumulative Revenue Generated (in billions) |
|---|---|---|---|---|
| 1986 | $15.00 | 2.28% | $.342 | $1.710 |
| 1987 | 15.00 | 2.28 | .342 | 1.368 |
| 1988 | 15.00 | 2.28 | .342 | 1.026 |
| 1989 | 15.00 | 2.28 | .342 | .684 |
| 1990 | 15.00 | 2.28 | .342 | .342 |
| 1986 - 1990 TOTAL | | | | $5.130 |

This is a very rough yet very conservative estimate given the level of actual savings during the last five years. The methodology associated with this estimate is located in Appendix 1.

## Advance Refunding of Public Purpose Debt is an Important Financial Management Tool

It's ironic that while the present Administration is proposing New Federalism, it also seeks to hamstring the financing flexibility of state and local entities. Advance refunding—or debt restructuring—is a necessary tool, a tool which administrators use to reduce debt service costs, remove restrictive debt covenants, and adjust debt structures to varying economic conditions in their area. It just doesn't make sense to enact the New Federalism proposals, which force state and local entities to find new sources of revenues for existing service, while at the same time removing their ability to manage their financial situation in a cost-effective and financially prudent manner. The President's proposal seeks to do just that.

Advance refunding is important. It's important for states like Idaho where, in the first half of 1985, advance refunding saved seven Idaho school districts over $1.9 million through debt restructuring. Advance refunding helps local entities to structure their debt in a prudent fashion. Let me briefly describe several other examples from Idaho and one from Oklahoma in which advanced refunding of public purpose tax-exempt debt achieved significant public purpose goals.

Independent School District of Boise City, Idaho. In June of 1983, this School District completed an advance refunding of its outstanding bonds. Because of the growth and resulting pressures to expand, it had been forced to issue bonds at extremely high rates in 1982. Those bond issues had interest rates in excess of 11% and wre not callable until 1987. In 1983, the District was able to refinance this debt at an average rate of 7.97%. However, this was not the primary purpose for the refunding. Rather, it wanted to restructure its debt service. By this restructuring the District achieved more level debt service payments. The District has, therefore, been able to avoid any significant increases in property tax mill levy. There are several other factors which caused basic schools to pursue this prudent restructuring.

First: State funding was reduced.

Second: State aid payments are received on a deferred basis.

Third: Payment dates did not coincide with tax collections.

Therefore, our School District met several budget objectives without additional property tax increases.

Cassia Twin Falls and Oneida County Joint School District No. 151, Burley, Idaho. This school district is located in south central Idaho, in the town of Burley, which has a population of slightly more than 8,000. The School District itself has enrollment of approximately 5,000 students. This is a smaller school district in our state in a heavily agricultural area (more potatoes are shipped from Burley than from any other shipping point in the United States). The School District held a bond election in 1984, asking for authority to build new facilities. That school bond election failed. The needs of this school district were, therefore, to provide classroom facilities in the absence of voted authority from the electorate. By an advance refunding they were able to save approximately $95,000 in the 1984/1985 school year. While $95,000 may not sound like a significant amount of money in these times, it was sufficient to enable them to buy a portable classroom building. That portable classroom building assisted them in meeting some of their facilities needs that were not approved by the voters.

As you can see, advance refunding can be important to rural municipalities and school districts. The magnitude of the dollars, while not great, has a very significant impact on this school district and its ability to deliver education in a smaller town.

Idaho State Building Authority. This state issuer had to finance the construction of a state office building in 1978. At that time there was significant litigation regarding the ability of the state to finance such activities. The original bond issue was therefore structured with a number of covenants creating excessive reserve fund which safeguarded the state from an adverse outcome in these lawsuits. In the intervening years, these lawsuits have all been resolved in favor of the State of Idaho. However, the restrictive covenants remain. Therefore, an advance refunding was pursued in order to relieve the state of these covenants.

This transaction was in progress as of mid-summer 1985. It will result in a reduction of rents payable to support debt service by approximatley $200,000 annually. Despite this significant savings, the restructuring of the state's covenants were equally important.

Stillwater Medical Authority, Stillwater, Oklahoma. This refunding issue resulted in a significant debt service savings and released restrictive covenants in the bond indenture. The 1982 Series was issued at very high interest rates and required a bank letter of credit to permit the construction bond to be sold in 1982. The letter of credit had a 1% annual fee. By refunding, the hospital was able to obtain bond insurance due to tis proven track record of financial performance following the new construction. This allowed for the refinancing into lower interest rates and the removal of the need for the letter of credit and the elimination of the 1% annual fee. In addition, a portion of the debt reserve fund was released to be used by the hospital.

In summary, advance refunding of public purpose debt is an important tool for municipalities and their taxpayers. Private corporations are much more fortunate than public entities when it comes to flexibility in financing their own capital projects. A corporation has many credit avenues open to it during times of high and fluctuating interest rates. Short-term lines of credit from commercial banks, the Euro-market, issuing stock, all these tools allow corporations to avail themselves of the most favorable cost of money. Most of these credit sources are not available to municipal borrowers. Further, any corporation could advance refund its debt.

Unfortunately, with the exception of advance refundings, municipalities have no such alternatives. When a public entity needs to borrow funds, it needs to do so quickly. For example, in areas of rapid growth, school districts have to meet enrollment growth by building new schools. If a school district is encountering 10% growth, it can't say to the student body "I'm sorry, you're going to have to wait three years until interest rates come down before we can build a new high school." It must, instead, borrow money and build new schools. But what if interest rates are in the double digit range, as they are two to three years ago? Unlike General Motors, the Cherry Creek School District can't hold off going into the long-term market by using short-term lines of credit or the commercial paper market. In fact, the Cherry Creek School District must go into the long-term bond market to finance its school expansion at whatever the prevailing rates are.

By the same token, in areas of economic decline advance refunding can provide debt restructuring which may allow a City to avoid defaulting on its debt. In Quincy, Massachusetts, for example, advance refunding may be needed to stretch out $25 million of debt now that the town's major employer (general Dynamics) has announced that it will shut down operations and lay off 4,000 Quincy taxpayers.

Clearly then, the ability to advance refund public purpose tax-exempt debt should be retained for state and local government entities. Advance refunding is a legitimate financial tool. Congress should not hamstring local entities and foreclose on their opportunities to benefit from changing economic and interest rate environments. Thank you for your time.

## APPENDIX 1

### Historical Revenue Estimation (1980 - 1985)

Step

1. Determination of SLGS volume 1980 - 1985.

2. Determination of average rate of SLGS 1980 - 1985.

### Historical Revenue Estimation (1980 - 1985)

3. Determination of rate of marketable securities for same period.

4. Calculation of differential between average rate on SLGS and average rate on marketable securities.

5. Calculation of revenue benefit to Treasury based on SLGS volume and actual average rate differential between SLGS and marketable securities.

### Future Revenue Estimation (1985 - 1990)

1. Estimation of future advance refunding volume.

2. Estimation of future SLGS purchases based on anticipated advance refunding volume and historical SLGS volume.

3. Estimation of conservative proxy for future differential between average rate on SLGS and average rate on marketable securities.

4. Calculation of future revenue benefit to Treasury based on estimated SLGS volume and estimated rate differential between SLGS and marketable securities.

## D. Definitions and Assumptions for Analysis

1. The following definitions were used in connection with the aforementioned methodology:

a. "Total amount of SLGS outstanding" (SLGS volume). Statistics were taken from the Monthly Statement published by the Bureau of the Public Debt, Department of the Treasury, March 1980 - February 1985. Data was not readily available for the period March 1985 - present. The volume figures account for net purchases of SLGS (new purchases minus new redemptions).

b. The "average interest rate on total marketable debt" equals the weighted average interest cost of actual outstanding marketable debt (e.g. T-bills, T-notes, bonds) as compiled and published by the Bureau of the Public Debt.

c. The "average interest on total SLGS" equals the weighted average interest cost of outstanding SLGS compiled and published by the Bureau of the Public Debt.

d. The "net different rates" between SLGS and marketable securities were calculated by subtracting the average interest on total SLGS from the average interest rate on total marketable securities.

2. The following assumptions were used in connection with the aforementioned methodology.

a. If SLGS were not issued (March 1980 - February 1985), the Treasury would issue marketable securities in the same proportions as the marketable seucrities for this period.

b. If SLGS were not issued in the future, the "cost" to the government would at least be equal to the narrowest rate spread between SLGS and marketable securities (March 1980 - February 1985) (2.28%).

c. We have not assumed any impact from proposed flat-tax legislation which arguably could increase yields on tax-exempt securities and therefore reduce spread between SLGS and marketable securities.

Testimony
of
Mr. Carl Reherman
Mayor
City of Edmond, Oklahoma
Presented to the
Senate Finance Committee
September 24, 1985

My name is Carl Reherman. I am Mayor of the City of Edmond, Oklahoma. I want to thank the Senate Finance Committee for holding hearings on the President's Proposals for Tax Simplification as they relate to tax-exempt financing.

My comments represent the views of my city which is the largest public power system in Oklahoma; of the Oklahoma Municipal Power Authority, a state agency selling power at wholesale to 26 Oklahoma cities; of the Municipal Electric Systems of Oklahoma, an organization of 60 municipal electric distribution utilities; and of the Southwestern Power Resources Association which represents over 200 cities and rural-electric cooperatives in the six state Southwest region.

Chapters 11.01 and 11.02 of the President's Tax Proposals will greatly increase the costs of municipal operations. Over the past five years cities have absorbed the costs of programs that once were supported or partially supported with federal revenues. Passage of these proposals will make it extremely difficult for our cities to continue to keep pace with the need to provide basic municipal services to our citizens.

The proposal to eliminate tax-exempt status on bonds if more than 11% of the proceeds benefit non-exempt persons strikes particularly hard at electric distribution cities. Since power plants take five years or so to plan and construct and are run for 30-35 years, they are built not just for today's needs but for future needs as well. It makes no sense not to sell any excess capacity in such plants, but if excess capacity is sold under these proposals, the tax-exempt status of the bonds will be eliminated. The present 25% limitation allows municipal utilities to build power plants with adequate reserves while also allowing sales to private utilities of excess capacity at a reasonable level if market conditions allow such sales. Reduction in the 25% limitation now in effect will work an extreme hardship on small utilities and might easily eliminate the ability we now have to compete with large private companies.

Nearly all of Oklahoma's medium sized cities of 15-40,000 population have a major industry which may use from 1-20% of that city's water, sewer or electric services. If the 1% limitation is passed, these cities could easily lose tax-exempt status for their basic utility needs. We urge the Senate to reject the attempt to destroy cities' ability to issue such tax-exempt securities as would be necessary to maintain such services.

The President's Proposals would secondly eliminate arbitrage earnings on tax-exempt securities issued. Our cities will need construction funds in the near future for power plant construction. We may be five or more years in the process of insuring electric service to our citizens. The President's Proposals to eliminate arbitrage will restrict our ability to make economic decisions. Our bond issues will not be structured to meet construction criteria but criteria to meet standards for tax-exemption and arbitrage.

By eliminating arbitrage, Congress will only increase consumers electric bills because arbitrage funds used in construction will no longer be available to fund construction.

Since bonds will be issued more frequently under the proposal to meet the deadlines of complete expenditure of bond funds in three years and significantly depleted in the first month, there will be more issuance, bonding, legal and banking costs involved in plant construction. These costs too will be passed to consumers. This trade-off of higher consumer electric costs for a minor increase in federal tax collections makes little economic sense to our utilities.

Current tax law allows the issuance of bonds to refund outstanding bonds prior to the outstanding bonds' due date. The advance refunding of outstanding bonds by tax-exempt entities would be prohibited by the President's tax proposals. Many Oklahoma cities have in the past year used advance refundings to take advantage of current interest rate savings. Bonds which were refunded were for water systems, power projects, and municipal hospitals. Some refundings were necessary to refinance debt because of financial difficulties experienced due to the recessionary Oklahoma economy.

If the President's proposals are adopted, our cities and utilities will be restricted unnecessarily from access to the capital markets. This lack of access to capital markets to take advantage of currency fluctuations will result in higher hospital costs, water rates, and electric rates.

Furthermore, our electric systems which operate with a higher proportions of debt to equity than other utility functions will be restricted in their ability to provide competitive electric rates to consumers if the same financing alternatives in refinancing are not available to us as they are to private or cooperative utilities. We can see no reason why our cities should not be able to exercise sound financial management. There is no adequate reason to restrain our ability to take advantage of market changes in interest rates nor is there sound reason to prohibit us from refinancing our debt during times of economic hardship.

Finally, the President proposes to eliminate or reduce the deduction banks can take on the interest paid on funds borrowed to purchase tax exempt securities. Banks may now deduct 80% of the interest paid on such borrowed funds.

Although all entities which issue tax-exempt bonds will see higher borrowing costs for all public projects should this measure be enacted into law, the measure will be especially harmful to smaller rural municipalities. Interest costs on debt to small cities is always much higher than the interest paid by larger cities. This is due to the smaller size of the debt issue, the uncertainty of small cities' financial positions, and the lack of bond ratings for these cities.

During the period from 1980 to 1983 small cities in Oklahoma were dependent upon local banks to purchase bonds for necessary capital improvements such as EPA mandated sewage treatment systems. Often these cities would have to take time to help a local bank recruit investors to purchase a portion of an issue. It was a rare occasion when more than one bid might be made for a city's bonds during that period. Indeed, many rural cities borrowed money from the Farmers Home Administration because there were no buyers for their bonds even though coupons on such bonds were often 100-200 basis points above the interest rates paid by typical tax-exempt issuers.

Were it not for the local banks ability to deduct the interest costs of funds borrowed to purchase small tax-exempt issues, many of these cities in rural areas would not have been able to borrow funds for absolutely necessary projects. The Congress would certainly do a disservice to those cities as well as all issuers of such securities if the interest deductability were further reduced.

On behalf of the cities for whom I speak, I want to thank the Senate Finance Committee for holding hearings on these issues. I regret that the agenda was too lengthy for this presentation to be made personally and to be able to directly address questions you may have had.

Certainly the budgetary problems you face are difficult. We only ask that your efforts in tax reform do not take the course of crippling the financial market for cities nor of saddling us with higher costs of operations through changes in the tax code.

Again, we thank you for the opportunity to present this brief testimony and will be most happy to respond to any questions this committee or its staff may have.

# STATEMENT FOR THE RECORD

## GROUP HEALTH ASSOCIATION OF AMERICA, INC.

FOR THE HEARING ON
PROPOSED REPEAL OF THE TAX EXEMPTION
FOR NON-PROFIT HEALTH CARE FACILITIES BONDS

BEFORE THE
SENATE FINANCE COMMITTEE

SEPTEMBER 24, 1985
WASHINGTON, D.C.

Group Health Association of America, Inc. (GHAA, Inc.) is the national trade association for group and staff model health maintenance organizations (HMOs) representing nearly 75% of the national HMO enrollment. In the past year, HMO growth has risen at a 22% annual rate, demonstrating the growing acceptance of the prepaid group practice concept by employers, consumers and the Administration.

The Congress established public policy towards HMOs in 1973 with enactment of the HMO Act which encouraged the development of HMOs, and favored the creation of non-profit plans with a grant and loan assistance program. Proprietary HMOs were limited to federal loan guarantees only for development in underserved areas. Although the grant and loan program has now been phased out, non-profit HMOs were the model for the HMO movement. These non-profit plans were the measure for further growth in the HMO industry, including proprietary HMOs which have experienced a phenomenal growth rate in the past few years. This was an intended and successful ingredient of the national HMO strategy.

The success of the experience of some of the well established non-profit HMOs, such as the Kaiser Foundation Health Plan, Group Health Cooperative of Puget Sound and HIP of New York, contributed greatly to interest in developing HMOs among insurance companies, private investors and for-profit providers. Indeed, under private sector programs, their plans rendered direct technical assistance and advice to the nascent proprietary HMO industry.

The value of those non-profit plans includes their local governance and management and their ability to be responsive to the needs of their enrollees and their local marketplace. In order to have competitive premiums, keep up with technology and meet growing capacity needs, non-profit HMOs with a 501(c) (3) tax classification as a charitable organization, rely in large part on tax exempt bond financing to raise capital to construct and renovate ambulatory care facilities, acquire equipment, refinance existing taxable debt, and in the case of non-profit HMOs which own their own hospitals--construct new hospitals or renovate existing facilities. Access to tax exempt financing allows non-profit HMOs to acquire capital at lower interest rates as well as allowing long-term financing for assets such as medical facilities and hospitals, which are long-term in nature. However, they represent only a small fraction of the total activity in tax exempt bond financing. The Administration tax reform proposal to eliminate private purpose tax exempt bond financing would have a severe impact on non-profit HMOs--affecting the ability of existing plans to grow to meet the demands of enrollees and discouraging the start-up of new non-profit plans.

HMOs, by their nature and by law, provide health care services with an emphasis on preventive care to enrollees who reflect the age, social and income characteristics of their service area. The benefit of HMOs to the community includes their development of health care facilities in underserved areas. Denial of tax exempt bond financing could severely impact development and growth of these facilities in underserved areas.

As part of the ongoing national policy to encourage health care cost containment, the Administration has created programs and provided incentives which encourage HMO enrollment by Medicare and Medicaid beneficiaries and federal employees and their dependents. In 1982, under the Tax Equity and Fiscal Responsibility Act (TEFRA), a new program was created which promotes HMO enrollment by Medicare eligibles. A new health care option has been created for Medicare beneficiaries which provides, in many cases, a benefit package richer than the basic services required under Medicare, for a fixed premium. The program allows a payment to the HMO which generates savings for the government but which is consistent with the prepaid concept. As a result, the Department of Health and Human Services (DHHS) is estimating there will be up to 600,000 new Medicare beneficiaries enrolled in HMOs in the next three to four years. Given the higher utilization of health care services by the elderly, capital for new facilities and equipment will be urgently needed to meet the needs of this expanded Medicare enrollment.

In 1981, under the Omnibus Budget Reconciliation Act (OBRA), Congress granted states the flexibility to utilize alternative delivery systems, such as HMOs, for their Medicaid programs. A number of state and county governments in Michigan, Wisconsin, New York and California have turned to prepaid group practice as a way of ensuring access to high quality health care while holding down costs.

Federal employees and their families also have an opportunity to enroll in HMOs and receive a comprehensive benefit package for which the government pays a portion of their premium, under the Federal Employees Health Benefits Program (FEHBP). Currently, approximately 191 HMOs participate in the FEHBP and 84 new HMO applications were recently approved for 1986 participation.

The carefully crafted public policy to encourage public and private enrollment in HMOs would be impacted by eliminating private purpose tax exempt bond financing for non-profit HMOs. These HMOs would have difficulty obtaining the necessary capital to modernize existing facilities and expand to meet growing enrollment. Although a few of the older, well-established non-profit plans would have a credit rating which might let them compete in the commercial lending market, none has access to the equity market as do proprietary plans. For example, The HMO Group, composed of 11 HMOs located in New Jersey, New York, Washington, D.C., Connecticut, New Hampshire, Missouri, Rhode Island, Washington and Minneapolis which serves approximately 1.2 million members, has developed a capital financing program to reduce financing costs in order to remain competitive with propriety HMOs that are able to obtain access to low cost capital. Under this program, tax exempt revenue bonds will be issued through several state bond authorities in a collective offering under the auspices of The HMO Group. In order to assure continued growth of these HMOs over $40 million is required for construction and refinancing of ambulatory medical centers. The collective issuing of bonds will enable these HMOs to obtain credit enhancement through "AAA" rated banks' letters of credit which will generate both debt service and administrative savings.

For those who could raise capital in the taxable commercial market, the increased costs of capital would add approximately 10-15% to the costs of each project or 1-2% in additional costs each year. The increased costs would be reflected in higher premiums for the consumer and the employer (often state and local government), just as the savings achieved by using tax exempt financing now minimize increases in premiums. At the same time, small HMOs would not be likely to have access to capital in the commercial market at all and would have no comparable source for meeting capital needs.

Limiting access to capital for non-profit plans or increasing the costs for raising capital, would also have an impact on the government. Higher HMO premiums and limited capacity would affect the government as a third party payor. Although part of the Treasury Department's rationale for eliminating private purpose tax exempt bond financing is erosion of the federal tax base, federal expenditures would rise under Medicare, Medicaid and the FEHBP if the Administration proposal were enacted. For example, Health Insurance Plan (HIP) is the country's second largest HMO, currently serving over 880,000 members throughout the New York metropolitan area through 57 health centers and two HIP hospitals. Additional hospital care is provided at other hospitals throughout New York. As a result of New York State legislative action last year, the State's hospital financing agency (MCFFA) is now authorized to issue tax exempt bonds to finance the construction, renovation and expansion of HMO health centers. MCFFA will be issuing tax exempt bonds this month to HIP for health center projects, including many projects located in the five burroughs of New York. Had this form of financing not been available, the estimated additional cost to HIP's subscribers of a taxable financing in the same amount would range from $23-33 million. Since 60% of HIP's subscribers are federal, state and municipal employees, government in its role as an employer would be burdened with a large portion of these extra costs.

In addition to the Administration proposal to repeal tax exempt bond financing for non-profit health care organizations, the proposal would restrict arbitrage and eliminate advance refunding for tax exempt bonds. The Group Health Cooperative of Puget Sound, serving approximately 380,000 consumers in the state of Washington through 20 primary care medical centers and two full service hospitals they own and operate, estimates that with their planned issuance of bonds to advance refund two 1982 bond issues, they will achieve a savings of approximately $8.9 million. This will translate directly into a savings for Group Health Cooperative consumers in terms of minimization of premium increases. We urge preservation of the current system of arbitrage and advance refunding.

In conclusion, the rapid growth of alternative health care delivery systems and their enormous impact on containment of costs and quality of care, is directly attributable to the carefully drawn Congressional policy of achieving a national role for both non-profit and proprietary systems. In any constructive marketplace environment, denial of a major source of financing for non-profit HMOs could well skew this carefully measured balance.. We urge and support continued availability of tax exempt bond financing for non-profit HMOs.

85-8

Policy Position Regarding

REVISION OF TAX-EXEMPT STATUS FOR STATE BONDS

Submitted by: Governor Bob Graham, Florida

Adopted at the 1985 Annual Meeting of
The Southern Governors' Association
September 10,1985

Background

Within the next few weeks, the House Ways and Means Committee is expected to take action on a package of legislation based in part upon the President's recent tax reform proposal.

The President's proposal contains a series of provisions which would severely restrict the traditional tax exemption for bonds issued by state and local governments.

The President proposes three changes in the federal law governing tax exempt financing that are of acute concern to state and local governments:

1. the prohibition of advanced refunding of existing bond issues;

2. the requirement that a "significant proportion" of the bond proceeds be spent within one month of the bond issue and that all proceeds be spent within three years of issue; and

3. the elimination of the tax exemption for bond issues in which more than one percent of the proceeds are used by a nongovernmental entity.

Advanced refunding of outstanding bonds is done in order to give taxpayers the benefit of lower interest rates than were available at the time the bonds were issued. Prohibition of this practice will increase costs for taxpayers.

The rapid disposition of debt proceeds requirement would force state and local governments to issue bonds with much greater frequency than is now common. Because certain fixed costs attend all bond issues, regardless of their size, more frequent issuance would increase the cost of issuing bonds.

The "one percent test," which would be used to distinguish allowable from non-allowable bonds under the President's proposal, would eliminate not only small-issue industrial development bonds for private purposes, but would also eliminate bonds for air and water port facilities, single- and multi-family housing, pollution control projects, student loans, solid waste disposal, and perhaps water and sewer construction.

## Recommendations

In recent years, Congress has adopted a number of limitations on the use of tax exempt debt. These restrictions were intended to assure reasonable use of tax exempt financing and, although this goal has been substantially achieved, some additional refinement of the law may be in order. However, the Southern Governors' Association believes that the effort to prevent misuse of tax exempt financing should not serve as a cloak for substantial elimination of this important mechanism for financing the legitimate activities of state and local governments. Nor should it preclude the achievement of important public goals through public-private partnerships.

It is the Association's belief that in drafting tax reform legislation, Congress should recognize that the bond provisions in the President's proposal constitute an assault on the tax exemption for state and local borrowing, not merely an effort to eliminate abuses connected with private activity bonds. If Congress is concerned with preventing alleged abuses in tax-exempt financing, it should enact legislation enumerating and prohibiting these abuses. If Congress is concerned with limiting the overall volume of tax-exempt bonds, it should continue the current volume "cap" system. Finally, if Congress considers a clearer definition of legitimate public purposes for tax-exempt financing essential, it should address the definition problem, instead of adopting an unworkable measurement of "private benefit" which could ultimately make all state and local bonds taxable.

# TESTIMONY OF MAYOR EDWARD I. KOCH

# SUBMITTED TO THE SENATE COMMITTEE ON FINANCE

# CONCERNING PROPOSALS FOR TAX EXEMPT BONDS

SEPTEMBER 24, 1985

The Reagan Administration's program for tax reform, contained in a set of proposals known as Treasury II, will have a significant and adverse impact on a key financing tool utilized by municipal governments, the issuance of tax-exempt debt. If adopted as proposed, these elements would cripple New York City's efforts to rebuild its aging infrastructure including its City-owned hospitals, force it to reduce and defer major new capital improvement programs, such as resource recovery for waste disposal, call a virtual halt to the creation of multi-family housing for low- and moderate-income families and wipe out vital programs providing low-cost financing to businesses along with the concomitant job opportunities they offer. All of this would occur at a time of massive federal budget reductions for domestic programs in these same areas of housing, health, environmental protection, employment and training and economic development.

There is one element of the Administration's tax proposal which I am forced to oppose above all others - - the repeal of the deduction for state and local taxes - - because of the discriminatory impact it would have on my City and State and because of the damage it would do to the principle of federalism, so fundamental to our nation's system of government. However, these tax-exempt debt proposals would have a severe impact on the quality of life for the people of New York City, especially those who depend most on government services and infrastructure.

Neither these tax-exempt debt proposals nor the elimination of the deductibility of state and local taxes is essential for revenue-neutral tax reform. The federal tax code can be made simpler and fairer without dismantling the foundation of our federal system and without destroying state and local governments' ability to borrow for public purposes at favorable rates. The expected Treasury savings from the tax-exempt debt proposals contained in the Administration's plan are relatively modest. Replacements can easily be found for the $3- 4 billion these provisions are expected to save annually. Far less apparent, on the other hand, are the programs and procedures, and the wherewithal to implement them, which would replace the tax-exempt debt option in stimulating the provision of vital public goods and services.

This testimony is restricted to the topic of the Administration's proposals related to tax-exempt debt. It does not, therefore, respond to many of the questions raised by the staff alternative prepared for the House Ways and Means Committee released on September 26th. It should be noted, however, that the City has serious reservations regarding those proposals as well, and we intend to voice these concerns over the coming days.

The Treasury II proposal would deny the federal tax-exemption to debt issued where more than 1 percent of the proceeds of the bonds either directly or indirectly benefit a person other than a state or local government. Its effects on the City's housing, resource recovery, economic development and medical facility capital programs would be devastating. In addition, proposals to restrict arbitrage earnings and the abilities of tax-exempt borrowers to refund bonds in advance of their maturity will make many worthwhile public projects infeasible.

Small issue industrial revenue bonds (less than $10 million ) which provide below-market rate financing to businesses, would be eliminated under the Treasury II proposals. These bonds are used to channel private capital into socially beneficial investments that would not occur otherwise. In much the same way that the tax exemption on interest paid on home mortgages stimulates the private housing market, the tax exemption for interest earned on small business loans makes such financing more readily available and thereby induces additional jobs to be created and retained.

New York City's fiscal crisis is often attributed in large measure to the erosion of its tax base caused by the mass exodus of manufacturing firms during the 1960's and 1970's. Indeed, the City's future continues to depend on its ability to retain its current mix of industrial and commercial jobs as well as create future employment opportunities. Small issue IRB's have been instrumental in retaining many businesses and are an important tool in the City's effort at insuring that industry flight and massive job loss does not occur again and that new jobs are created in sufficient numbers to employ the City's labor force.

The availability of affordable housing is another critical factor in the economic future of New York City. Recent studies have shown that a constricted housing market has the potential of stifling the City's economic growth. Market forces alone are unable to provide the type of housing needed by the majority of city residents. It is anticipated that at the rate new units are now entering the market, less than half of the projected 2.7 million new families in New York City will find a place to live by the year 2000.

In addition, New York City's waste disposal problems have reached the crisis stage. Landfill sites will reach their capacity shortly. New methods of waste disposal must be developed immediately. Only through IRB financing can the construction and operation of resource recovery facilities be made financially feasible for New York City.

Finally, the City's municipally owned hospitals are anticipating capital needs of $1.5 billion over the next ten years, $1 billion of which is expected to be raised through the issuance of IRBs.

The importance of IRB financing to New York City's future cannot be overstated.

## INDUSTRIAL REVENUE BONDS FOR ECONOMIC DEVELOPMENT

The New York City Industrial Development Agency (NYCIDA) is the principal vehicle for issuing small issue industrial revenue bonds to promote job opportunities and economic development in New York City. The NYCIDA is a not-for-profit public benefit corporation which issues tax-exempt IRB's to encourage economic growth and expand the industrial base of the City. The NYCIDA provides access to capital to facilitate the construction, acquisition, rehabilitation or improvement of real property and/or the purchase of machinery and equipment.

The NYCIDA is particularly selective about the projects it approves for financial assistance. To qualify, a business must demonstrate that it will provide substantial employment opportunities, is financially viable and that the project would not be economically feasible without IRB financing. For the firms applying for IRB financing, tax-exempt debt holds the key to their economic viability in New York City. In the case of many small businesses in New York City, cash flow may not be sufficient to support debt service on taxable debt. These small businesses would not be able to undertake the proposed project at taxable rates, and as a result, the expansion and subsequent job creation would not go forward.

Since 1976, the 389 projects financed by the NYCIDA for $583 million have been responsible for retaining 34,602 jobs and creating 17,471 others. Many of these are low-skilled jobs offering opportunities for employment in economically distressed areas. Over 79 percent of these jobs went to residents of New York City. In addition, the majority of the participating firms are small businesses with less than 100 employees.

Currently, the New York City IDA is actively working on a total of 115 business loans, the likes of which would no longer be granted tax-exempt status under Treasury II. Of these 115 businesses, 95 have made a substantial investment in their projects and have received inducement resolutions from the NYCIDA Board but have not yet closed. These 95 projects for $262 million in bond financing would retain 6,255 jobs in New York City and create an estimated 4,794 jobs. The 20 remaining projects in the pipeline are in various stages of development. These 20 projects anticipate using $62 million of IRB financing to retain and create nearly 3,000 jobs. This means in the short term the tax reform proposal would threaten over 14,000 jobs in New York City's already beleaguered industrial sector.

In addition to the NYCIDA, industrial and commercial businesses in New York City have also obtained financing through the New York State Job

Development Authority (JDA), the statewide issuer of industrial revenue bonds. From January 1980 through August 1985, JDA has approved $20,969,000 in below market rate loans to 79 New York City-based companies. The majority of these firms have been small businesses expanding their operations in New York City. As a result, it is anticipated that JDA financing will lead to the retention and creation of 6,936 jobs. Tax-exempt financing of this type would be prohibited by the President's proposal.

The widespread and quite formidable economic benefits of small issue IRB's far outweigh their costs to the government. The interest savings the firm receives are dedicated to present and future development of the firm and the overall economy through new jobs and payroll, plant expansion and local sales. IRB investments stimulate new economic growth and provide additional tax base for the local, state and federal government. Because they do not account for this effect, the estimates of federal revenue to be gained by the elimination of small issue IRB's are greatly overstated. Projected revenue savings assume the same level of financing as would occur under current law, even after the loss of the tax exemption.

The Deficit Reduction Act of 1984 (DEFRA) has already placed substantial restrictions on the IRB program. At that time, Congress made a close examination of the program and attempted to reduce the volume and focus of IRB issuances nationwide. Until the results of these actions are known, it would be unwise to make yet another round of drastic policy changes, let alone count on these new changes to generate a specific amount of additional federal revenue.

During the debate on DEFRA, the concern was raised that industrial revenue bonds crowd out other governmental borrowings in the capital market and thereby raise the total cost of all tax-exempt debt. However, recent evidence indicates that small issue IRB's only have a minimal effect on interest rates for other tax-exempt issues because IRB's do not compete for the same source of capital. In contrast to traditional state and local debt which is mainly purchased by private individuals, the overwhelming majority of IRB's issued by the NYCIDA are purchased by the firm's local bank. According to a recent study by the Council of Industrial Development Bond Issuers, over 75 percent of all small issue IRB's were purchased by banks and only 18 percent of these banks sold any of their bonds on the secondary market. Therefore, the impact of small issue IRB's on other tax-exempt debt is greatly overstated.

The IRB program is an important source of capital to this country's industrial sector. This sector has already been hurt by two back-to-back recessions followed by a strong dollar abroad and foreign competition at home. In order to strengthen our manufacturing base, there needs to be a substantial investment to retool and update the capital stock to be up to date with the latest technological innovations. Small issue industrial revenue bonds are one of the few financing tools available to encourage this important national goal.

## RESOURCE RECOVERY FACILITIES

To ensure that New York City remains able to safely handle all of its essential disposal needs, the City has begun a program to develop 18,000 tons of daily resource recovery capacity within the next ten years, and to reduce its disposal requirements by recycling approximately 15 percent of its waste stream. This program is designed to prevent the serious waste disposal problem which now exists from becoming a waste disposal crisis. It is obvious that to maintain adequate waste collection service the City must have adequate disposal capacity.

At the end of this year, the City will lose about 40 percent of its daily disposal capacity. At that time, the Fountain Avenue landfill in Brooklyn will close pursuant to the agreement that permits the City to landfill at that federally owned site. Closure of that facility means extra pressure on the one other active landfill in the City.

Proven resource recovery technologies offer the most viable long-range solution to the City's waste disposal problem. This is because resource recovery (the combustion of refuse and generation of steam and/or electricity in precisely designed and operated facilities) is the most environmentally acceptable and resource-efficient method for disposal of municipal solid waste. In fact, Congress has made clear in the federal environmental laws that it is national policy to develop resource recovery facilities. Existing federal environmental regulations are designed to encourage resource recovery and to discourage landfilling.

However, it is the private sector that is best able to provide the construction and operational expertise for resource recovery facilities. The technology employed in the safest, most reliable systems is not now within the public domain. Its development has been the subject of a decade or more of research and development by the private sector. The luxury of time to overcome existing institutional barriers and build in-house technical expertise does not exist for New York City, where landfill space is rapidly running out.

The pyrolosis plant constructed in Baltimore and the Refuse Derived Fuel (RDF) plant constructed in Chicago are just two examples of experimental facilities which have failed. We cannot afford failure, either practically or economically, and therefore must rely on the proprietary systems and expertise of the private sector, which have a proven record of success.

For these reasons New York City, like many other localities, will enter into full-service contractual arrangements for design, construction and long-term operations with systems vendors (i.e., private developers/ operators). Under these arrangements the system vendor assumes substantial risk for non-performance of a facility. This results in assurance to the municipality that the environmentally safe disposal services needed will be delivered on a continuing reliable basis. However, even though the private sector will construct and operate these facilities, they remain public purpose projects in the truest sense of the term.

Last year this Committee and the House Ways and Means Committee agreed that unlike some areas where IDB financing has been abused, resource recovery projects are only constructed for an essential public purpose. Both committees also recognized how important it is for localities to have these facilities provided by the private sector.

Resource recovery projects merit tax-exempt financing just as does any other governmental public purpose project because it is the service recipient - - the general public - - which benefits from lower waste disposal costs as a result of lower interest rates. The proposed tax law changes would severely penalize the City for taking the most prudent and responsible course available for handling its waste disposal needs - - development of resource recovery facilities which are privately owned under long-term full-service contracts which require the vendor to make an equity contribution and guarantee long-term operational performance.

The Deficit Reduction Act of 1984 (DEFRA) includes a special rule that defines service contracts for waste-to-energy facilities that serve the general public, enabling these projects to qualify for tax-exempt IDB financing, investment tax credits and the accelerated cost-recovery system (ACRS). These rules specify the risks, burdens and benefits that must remain in the private sector in order to entitle an equity investor to tax ownership.

These rules define public purpose, public-use resource recovery facilities as:

> "A facility is a qualified waste disposal facility if: (1) such facility provides waste disposal services for residents of part or all of one or more governmental units; and (2) substantially all of the solid waste processed at such facility is collected from the general public."

We recommend retention of this definition because it excludes private facilities constructed for the purpose of waste disposal for private industrial waste of one or more private entities, but would include public purpose, public-use resource recovery facilities.

Resource recovery has the potential for turning a national liability - - municipal solid waste - - into a national asset, and in effect would make this country less dependent on foreign sources of energy. Resource recovery is also a notable example of the private and public sectors joining together to solve a local government problem at less costs and risk to a locality than the traditional means employed by public entities.

New York City has estimated that as a result of Treasury II the annual costs of operating resource recovery projects would increase from between $213 million and $260 million to between $348 million and $420 million. Most of these additional costs would result from the loss of tax-exempt financing. The continued availability of IRB financing is crucial to the City's ability to afford the massive investments needed to construct the necessary resource recovery projects.

## HOUSING

New York City faces an acute shortage of affordable housing for a large number of low- and middle-income residents seeking shelter. The City has a vacancy rate of only 2 percent. When occupied, delapidated units are dropped from the calculation there is actually a negative vacancy rate. The housing market is getting tighter each year because the City is gaining more households than housing units.

Between 1981 and 1984 the federal budget for housing was cut from $30 billion to $9.9 billion, making the City's job in dealing with its housing shortage all the more difficult. The City is attempting to alleviate this housing crisis by using tax-exempt financing tools - - single family mortgage revenue bonds (MRB's) and multi-family industrial development bonds (IDB's). It also uses capital budget dollars raised through general obligation bonds to finance rehabilitation of abandoned buildings for reuse by low- and moderate-income residents. All are threatened by the tax exempt bond proposals of Treasury II.

The State of New York Mortgage Agency currently issues MRB's in order to provide financing for first-time homebuyers in New York State to purchase new single-family homes or existing 1-4 family structures. Presently, it is the only source of below-market, fixed rate mortgage money for first-time homebuyers in owner-occupied housing. The elimination of MRB financing would make it more difficult for the increasing numbers of residents seeking housing to afford to purchase new or rehabilitated housing. In addition, it would severely impair or eliminate many of New York City's neighborhood revitalization and stabilization projects which are centered around the construction of new homes or the rehabilitation of existing units.

Currently, the City, in partnership with community organizations and foundations, has plans to add upwards of 10,000 units of housing in economically distressed areas of New York. These programs leverage city capital budget monies of $10,000 per unit with MRB's and private development capital. Without tax-exempt financing to provide permanent financing, the City's direct contribution to each of the planned developments would have to be substantially increased if the homes are to remain affordable to low- and moderate-income families. If the City were unable to increase its share of financing, the homes would have to be marketed to higher income families.

More critical in the City's efforts to provide housing opportunities for its low- and moderate-income residents is the tax exempt financing it uses to provide multi-family rental housing. IDB's are issued by the New York City

Housing Development Corporation for the production of new or substantially rehabilitated mixed-income rental housing. The program requires that at least 20 percent of the units in any project must be occupied by households earning less than 80 percent of the area's median income at the time of initial occupancy. The availability of tax-exempt financing can result in cost savings of between 30 and 40 percent which in turn can make housing projects feasible where they otherwise would not be, and enable the owner to offer a number of units at rents which are affordable to low-income families.

The City, in conjunction with the State, has also just announced a landmark $1.2 billion commitment to devote growing amounts of municipal funds as well as funds acquired from such innovative sources as the Port Authority and Battery Park City Authority to produce low- and moderate-income housing. The City plans to utilize tax-exempt financing to leverage these funds and generate private capital sufficient to construct or rehabilitate over 70,000 units in the coming years. These units are essential to address the City's housing crisis, and tax-exempt financing is essential to produce these units.

Although the existing IDB provisions for multi-family housing require at least 20 percent of the tenants to be low-income, there are additional ways to insure that the program's benefits are effectively targeted. In fact, the City of New York has voluntarily instituted systems to require an adequate supply of larger units and to adjust the income eligibility limits according to family size.

Other communities throughout the nation have also implemented their own specific requirements to assure that the program meets the needs of their residents. The City of New York supports any efforts on the part of the Federal Government to encourage localities to further tighten the program and better target its benefits as long as those efforts allow the locality some flexibility in doing so.

In addition to not being able to issue IRBs for housing, the City would be prevented from issuing its general obligation debt to finance housing projects it does not own because of the proposed 1 percent rule. The City's program to house the homeless, which utilizes general obligation bond proceeds to finance the rehablitation of vacant or substantially vacant tax-delinquent buildings would be severely hampered. New York City has already rehabilitated approximately 5,000 units for the homeless and intends to produce as many as 4,000 new units each year. Many of these units are in buildings targeted to be sold to non-profit groups that will own and manage them as emergency shelters or permanent housing. None of these projects could be financed with tax-exempt debt under the Treasury II proposal.

Without the use of tax-exempt bonds, the City would be forced to issue taxable bonds or make direct expenditures from its treasury for the total amount of the construction. This would increase the cost of financing by 30 to 40 percent, and drastically limit the number of units that could be financed.

## HOSPITALS

The proposed 1 percent rule would jeopardize most of the projects planned by the City's Health and Hospitals Corporation by removing their tax-exempt status. Although HHC's hospitals are owned by the City, they are used by hospital affiliates and professional corporations who provide direct patient care service, as well as other groups, including service contractors and lessors. Therefore, more than 1 percent of the space or output of the facilities to be constructed will certainly be for so-called private use.

Furthermore, the taxable bond option might not be available for HHC projects except at truly prohibitive rates. This is the result of HHC's important role as provider of health care services to low-income people who are not covered by public or private insurance and have no ability to pay for services themselves.

Pay-as-you-go financing could become the only vehicle for raising the $1 billion necessary to undertake the 5 major hospital renovations planned for the next 10 years. However, even this option is unrealistic because of the formidable sums of up-front cash it would require, a ready source for which is not now identifiable.

## CONCLUSIONS

It is clear from the foregoing that tax-exempt financing is a critical instrument used by New York City to provide essential services to all its citizens and secure its economic future. Federal budget cuts in dozens of programs, including housing, CDBGs, UDAGs, transportation, Medicaid, EDA grants and employment programs have meant that localities must replace these lost dollars with sources of their own. In order to accomplish this most efficiently, localities must be allowed flexibility in meeting their financing needs. Tax-exempt debt allows governments to gain maximum leverage for their public monies and encourages public-private partnerships that increase the efficiency and lower the cost of delivering important public services.

Like most localities across the country, New York City has never abused the privilege of tax-exempt financing and, to the contrary, has carefully crafted programs to obtain maximum economic and social benefit. For example, NYC issued only $125 million of economic development IRB's in 1984 out of an annual allocation of $424 million. Similarly, New York City's Housing Development Corporation has tightened low-income requirements for its programs in several ways that exceed statutory requirements. Clearly, the City uses tax-exempt financing to obtain the largest benefit for the greatest number of residents, at the lowest possible cost to government - - City, State, and federal government.

Congress has acted on several occasions to require all localities to restrict their tax-exempt issues to the most important economic purposes.

Additional guidelines could target small issue IDB's to small businesses, better target MRB's and housing IRB's to low- and moderate-income families and allow tax-exempt financing only for those projects that clearly have a compelling public benefit. There is no reason why these programs should be eliminated; instead certain restrictions and targeting provisions can make all tax-exempt financing consistent with both national and local goals.

The City of New York is prepared to help this Committee in any way it possibly can to formulate alternatives to the Treasury proposals and evaluate their effects.

Kathryn McLeod Lancaster
267 C Seahorse Drive Southeast
St. Petersburg, Florida 33705

October 4, 1985

Ms. Betty Scott-Boom
Senate Committee on Finance
SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Enclosed please find five copies of my article on the impact of tax reform on tax-exempt bonds, as requested by Mr. William H. Diefenderfer in his letter dated September 9. This article is being submitted to the Senate Committee on Finance for inclusion in the hearing record (testimony was taken on September 24, 1985). I prepared this report ("The Federal Tax Proposals: How They Affect State and Local Government Bond Issues and Finances") as a comment for the Stetson University College of Law's Local Government issue of the Law Review.

Sincerely,
Kathryn McLeod Lancaster
Kathryn McLeod Lancaster
(813) 822-3575

Enclosures

# THE FEDERAL TAX PROPOSALS: HOW THEY AFFECT STATE AND LOCAL GOVERNMENT BOND ISSUES AND FINANCES - COMMENT

The calls for tax reform ring far and near.[1] As a result of these appeals, a large number of major Federal tax revision proposals are currently competing for the support of Congress and the Administration.[2] Most of these proposals include some form of a flat tax on all income.[3] Exclusions from income, exemptions from taxable income, deductions, and tax credits are drastically limited if not abolished altogether under the great majority of the suggested plans.[4] The espoused goals of such major overhauls aim for tax simplification, a more equitable tax structure, the elimination of tax incentives to channel funds in an inefficient manner, greater ease in tax enforcement, and the bolstering of national pride.[5] The objectives of the tax reform movement demand respect; however, the means of reaching these important objectives (i.e. the tax proposals themselves) may require further refinement to avoid the destruction of equally worthy governmental goals.[6]

Numerous special interest groups have voiced their objections to the Congressional bills as well as the Treasury's proposal.[7] A few proposals have provided concessions, while most proposals only appear to reduce the challenged effects.[8] The difficulties inherent in predicting the effects of major tax revision plans complicate the debates accompanying reform efforts.[9]

The Federal tax revisions now under consideration could affect or eliminate industrial development bonds (e.g. waste treatment, pollution control), homeowner financing bonds, student loan bonds, tax arbitrage (the investment of revenue derived from tax exempt issues), advance refunding of bonds by municipalities and states, the depository institution market for tax-exempt issues, state and local real property taxes, state and local personal property taxes, state and local income taxes, and state and local general sales taxes.[10] Consequently, the federal tax proposals being examined in the Capital could seriously alter municipal financing and operations - from the levying of real or personal property taxes to the contracting out of municipal services.

## IV. What the Flat Tax Proposals Provide The Quayle/Schulze SELF-Tax Act of 1984

One of the first Congressional flat tax bills still under consideration, the Quayle/Schulze SELF-Tax Act of 1984 (originally of 1983),[53] provides for five tax brackets ranging from 14% to 28% for individuals[54] with a single 25% bracket for corporations.[55] The entire bill consumes only four and a half pages. Section 4(a) of the Quayle Bill (ironically introduced as Senate Bill number 1040), repeals "all specific exclusions from gross income, all deductions, and all credits against income."[56] Thus, this SELF-Tax would effectively repeal the exclusion of interest on all tax-exempt bonds, the deduction of all state and local taxes, and any special capital gains treatment.

## The DeConcini/Shelby Flat Rate Tax System

Another bill introduced into Congress in early 1983, the DeConcini/Shelby proposal[57] presents a flat rate tax of 19% on compensation and taxable business income.[58] Under this bill, compensation includes "wages, salaries, pensions, bonuses, prizes and awards"[59] as well as "workman's compensation and other payments for injuries or other compensation for damages."[60] This definition of compensation excludes "goods and services provided to employees by their employer" such as "medical benefits, insurance, meals, housing, recreational facilities, and other fringe benefits."[61] The DeConcini/Shelby proposal defines business taxable income as "business receipts less the cost of business inputs, less compensation paid to employees, and less the cost of capital equipment, structures, and land."[62]

Interestingly, the DeConcini/Shelby bill contains no provision imposing an income tax on the appreciation of previously taxed income.[63] As a tax on only compensation, this proposal excludes all interest received from investments such as bonds or dividends received from stock and any gain on the sale of investment property. By only taxing compensation and not taxing further return of income derived from the previously taxed funds, the DeConcini/Shelby bill alleviates the double taxation of income produced in corporations.[64] This one time tax on earned income could also substantially influence municipal finance.

This compensation tax proposal includes no section repealing the tax-exempt status of any bonds or creating additional restrictions on the qualifications of tax exempt bonds.[65] Nevertheless, by excluding all investment income from taxation, the DeConcini/Shelby flat tax confers tax-exempt status to all bonds, corporate as well as municipal. Likewise, this flat tax proposal treats all capital gains as tax-exempt so that investors would desire no special capital gains treatment.

### The Kemp/Kasten Fair and Simple Tax Act of 1984

In April of 1984, Senator Kasten and Congressman Kemp introduced their bill for the "Fair and Simple Tax Act of 1984".[66] This forty-seven page bill proposes a flat tax of 25-percent on the taxable income of individuals[67] and a tax of 15-percent on the first $50,000 of taxable corporate income with a 30-percent rate on corporate taxable income exceeding $50,000.[68] This bill excludes 20-percent of an individual's employment income (up to the FICA maximum wage base) and a limited amount of investment income (for individuals with less than $10,000 of employment income) from taxable income.[69] The Kemp/Kasten proposal equates employment income with earned income and classifies investment income as all non-employment income.[70] By excluding 20-percent of earned income and a small portion of investment income for low income taxpayers, the Fair and Simple Tax Act provides some degree of progressivity in its flat tax scheme.[71] The design of this bill broadens the tax base by eliminating exclusions, exemptions and deductions while lowering the taxation rate structure.[72]

Section 215 of this proposal repeals the tax- exempt status of interest on industrial development bonds as well as mortgage subsidy bonds.[73] The proposed alteration of the Code's section 103 would also disallow the exemption of interest derived from obligations incurred to finance student loans or tax-exempt organizations.[74] Section 501(e) of this bill states that the amendments applicable to tax-exempt bonds in section 215 only apply to obligations issued after the effective date of the Act (if enacted).[75]

A controversy appears to exist over what state and local taxes are deductible under the Kemp/Kasten proposal. The 1984 version of the bill, introduced during the second session of the 98th Congress as Senate Bill number 2600, never mentions a repeal of the deductions for state and local taxes or the section allowing the deductions under current law, code section 164.[76] Even so, the Treasury Department's Report to the President states that the Kemp/Kasten bill repeals state and local income taxes.[77] A separate report prepared by the Government Finance Officers Association states that the Kemp/Kasten proposal repeals the deduction for state and local income taxes, personal property taxes and general sales taxes.[78]

The Bradley/Gephardt Fair Tax Act of 1984

In June of 1983, Congressman Gephardt and Senator Bradley introduced their Fair Tax Act of 1983 to broaden the tax base while lowering tax rates.[79] Representative Ferraro, Senator Hart and Senator Kennedy listed themselves among the proposal's sponsors.[80] This 73 page bill imposes a "normal tax" of 14-percent of an individual's taxable income with a "surtax" of 12-percent of the individual's income over level I (but under level II), and 16-percent of the individual's income over level 1 (but under level II), and 16-percent of the individual's income over level II.[81] The resulting rate schedule has three tax brackets for individuals, 14-percent (of income below $25,000 for unmarried individuals or $40,000 on joint returns), 26-percent (of income below $37,500 for individuals or $65,000 on joint returns)[82] and 30-percent.[83] A flat "normal tax"[84] of 30-percent applies to the income of estates and trusts as well as to the income of corporations.[85]

Section 216 of the Bradley/Gephardt proposal substantially limits the bonds issues qualifying for tax-exempt treatment under the Code. This provision repeals the tax exemption for interest received on industrial development bonds, mortgage subsidy bonds, and bonds utilized to finance student loans as well as otherwise tax-exempt organizations.[86] Likewise, section 233 of this bill repeals the deductions allowable under Code section 164 for state and local sales taxes and personal property taxes.[87]

The Treasury Department Tax Reform For Fairness, Simplicity and Economic Growth:

On November 27, 1984, the Treasury Department, under the guidance of Donald T. Regan, revealed its modified flat tax plan to lower the tax rates and broaden the tax base.[88] By December 27, 1984, the Treasury Department had written over 800 pages to the President discussing the Tax Reform for Fairness, Simplicity, and Economic Growth, comparing it with the alternatives.[89] This modified flat tax has three tax brackets: 15-percent (for single individuals with taxable income from $2,800 to $19,300, for married taxpayers filing jointly with taxable income from $3,800 to $31,800, or for heads of households with taxable income from $3,500 to $25,000); 25-percent (for single individuals with taxable income from $19,300 to $38,100, for married taxpayers filing jointly with taxable income from $31,800 to $63,800, or for heads of households with taxable income from $25,000 to $48,000); and 35-percent.[90]

Working within its own expertise, the Treasury Department drafted a highly detailed technologically superior study of the current tax system and its perceived weaknesses.[91] As a result, the Treasury proposal contains a number of provisions altering less visual areas of the Code and Regulations which the Congressional bills failed to address. One of these areas receiving attention only in the Treasury's tax plan concerns the ability of banks and other depository institutions to deduct 80-percent of the interest paid on deposited funds utilised to purchase or carry tax-exempt bonds.[92] The Treasury's proposal eliminates this "loop hole" by disallowing interest deductions to the extent of the depository institution's tax-exempt security holdings.[93]

Two other provisions found only in the Treasury's tax reform project limit the activities of governmental issuers in relation to tax-exempt securities. The first restriction increases the current prohibitions against tax arbitrage by issuers.[94] Unlike the current Code, the Treasury's tax arbitrage provision also prohibits issuers from retaining unanticipated arbitrage and forces issuers to rebate profits derived from the investment of proceeds obtained through non-government purpose indebtedness.[95] In determining the amount of gain derived from tax arbitrage, issuance costs no longer enter into the calculation of bond yields.[96] Furthermore, the Treasury proposal provides stricter guidelines covering the temporary periods during which the present tax system allows the investment on tax-exempt bond proceeds.[97] In addition, the Treasury's plan prohibits the early issuance of bonds, requiring that the issuer expend a substantial portion of the securities proceeds within one month after issuance and that the issuer exhaust all funds within three years (as a general rule).[98]

The other provision with the Treasury Department as its sole proponant proscribes advanced refundings for all tax-exempt bonds, unless the issuer immediately utilizes the proceeds of the refunding to retire the prior bond issue.[99] Thus, contrary to current practice, issuers may only carry out an advanced refunding if the old bonds were immediately redeemed with the newly borrowed funds.[100]

This tax reform proposal also differs from its primary Congressional rivals (Bradley/Gephardt and Kemp/Kasten) in that it repeals the deduction for all state and local taxes bestowed in Code section 164.[101] Without the deduction in section 164, taxes imposed by state and local governments on real property, personal property, income, and sales create federal income tax deductions only when incurred in a trade or business.[102]

The Treasury Plan denies tax-exempt status for government obligations where a non-governmental entity uses over one percent of the funds derived from the issue, unless: (1) the proceeds financed facilities available to all members of the general public on an equal basis; (2) the proceeds funded facilities used by a private entity under a short-term management agreement; (3) the non-government person covers its proportional share of the costs; (4) the issuer allows the use of the proceeds for a reasonably necessary reserve fund; (5) the issuer invests the proceeds during the temporary period before use allowed under the arbitrage restrictions; or (6) the issuer deposits the proceeds in a bona fide debt service fund.[103] In addition, the proposal extends the reporting requirements for IBD's to all tax-exempt securities.[104] Under the Treasury's restrictions, tax-exempt obligations support only government purpose projects controlled by a governmental unit. Some non-government purpose issues under the Treasury proposal are student loan bonds, mortgage subsidy bonds, veterans' mortgage bonds, pollution control b-onds, and waste disposal facilities bonds, as well as practically every other form of IDB's.

## V. Potential Effects of the Proposal on Municipal Government Financing

Many municipal bond experts declined to discuss the possible effects of the federal flat tax proposals because of the lack of specificity and certainty surrounding the relevant provisions in addition to the extremely complex indeterminate variables involved in predicting tne economic outcome of any of the flat tax proposals.[107]

Charles McLure, deputy assistant secretary of the Treasury Department stated that the effects of the Treasury proposal can not be satisfactorily predicted through traditional economic forecasting methods because econometric models "can't tell the difference between a dollar of investment that's going into a building that will stand vacant and one going into a factory that will be productively used."[108]

The lack of uniformity among the predictions of tax analysts and economists evidences the difficulties involved in attempting to analyze the merits of a major income tax revision. On the one hand, former presidential economic adviser Martin Feldstein contends that the benefits of the Treasury plan are small in proportion to the resulting harm, while a Harvard colleague, Dale Jorgenson, asserts that the Treasury proposal increases the growth of the gross national product by 5-percent over the next seven years.[109] Most analysts indicate that Feldstein's predictions apply to the first few years under a modified flat tax plan, while Jorgenson's forecast depicts the long term economy.[110]

On a more specific level, some general consensus exists among municipal bond analysts as well. The major debates revolve around the degree of the effects and the possibility that such proposals may become law.[111]

According to a number of municipal bond brokers, if a tax revision eliminated other tax shelters, a 30-percent bracket still provides a healthy market for municipal bonds.[112] Other investment advisers suggest that current yields on municipal bonds are high enough to remain good investments for individuals in the 20 to 25-percent tax bracket, especially if other tax shelters are eliminated by the tax proposal.[113] But these experts still admit that such low brackets may adversely alter the market for tax-exempt bonds with normal lower yields.[114]

The majority of experts also feel that the dividing point for the lowest tax rate for retaining the prime marketing condition for municipal bonds exists in the range between the 30 to 35-percent tax rates.[115] Below this level, a triple-A, 10 7/8-percent corporate bond probably appears more attractive to some high bracket investors; however, the ability of municipal issuers to offer yields equaling 80 to 90-percent of Treasury yields, and the security inherent in any government backed issue allows the tax-exempt market to retain a substantial portion of its investors.[116]

## Proposal's Potential Effects on the Marketability of Municipal Bond Issues

Qualified home owner financing bonds, pollution control bonds and other non-governmental issues currently comprise a very large sector (62%) of the tax-exempt bond market.[117] Many sources contend that the elimination of the tax exemption for interest received from such non-governmental bonds helps to hold the remaining municipal yields down under a supply[118] and demand theory based upon a reduced supply. However, some municipal analysts state that the major problem is a lack of basic need for exempted securities under a lower tax bracket structure.[119]

These analysts agree that no matter how low the supply remains, if no demand exists for interest free bonds, municipalities must raise the yields offered on their obligations to compete with corporate bond issues.[120] In addition, many investment advisers point out that the 1982 tax revisions mandating the registration of practically all tax-exempt issues increased the cost of issuing municipal bonds and made tax-exempt securities less convenient than coupon bearing unregistered bonds.[121]

By decreasing the favored tax treatment of municipal bonds, the proposal correspondingly encourages investment into more favorably treated areas. Capital gains treatment, which the President desires to retain for the economy could provide greater tax advantages for real property investments than municipal bonds under a lower tax structure.[123] For example, if a taxpayer invests in real property for a period exceeding six months (one year for this example) and the real property appreciates substantially in value at the rate of ten-percent per year (not an unheard of occurrence in Florida), when the taxpayer sells this long term capital gains property at a profit, capital gains treatment taxes only 40-percent of his gain.[124] On the other hand, the same taxpayer receives only six percent interest on municipal bonds, an insignificant amount when compared to the appreciation in value (eight and six-tenths percent after tax here) of wisely chosen real property.[125] Therefore, in order to compete for investment capital, municipalities would have to raise the yields offered on their obligations. Thus, a reduction in the tax rates limits the ability of local governments to raise revenues through bond issues.

The Treasury's proposal to repeal the deduction of 80-percent of the interest incurred by depository institutions to purchase or carry tax-exempt securities can cause a reduction in the demand for municipal issues.[126] Because commercial banks currently hold one-third of all outstanding tax-exempt obligations, the magnitude of this potential reduction in demand is very great.[127] The Treasury Department's report to the President recognizes this danger to the municipal market, noting that only retail investors own a larger sector of the municipal bond market than commercial banks.[128] Nevertheless, the Treasury's report contends that the provisions of the proposal eliminating the tax-exempt status of "non-government" purpose bonds, prohibiting arbitrage bonds, and proscribing the advanced refunding of bonds limits the number of tax-exempt bonds available on the market thereby increasing the demand for municipal bonds.[129] Likewise, the Treasury Department maintains that the elimination of other tax shelters probably decreases the pressure on state and local governments to raise bond yields.[130]

Yet, in the opinion of municipal bond analysts from national brokerage firms, the lowering of the highest tax rate, a denial of a deduction for interest incurred by banking institutions to carry tax-exempt bonds, and the elimination of tax-exempt status for "non-government purpose" bonds combined with the recently enacted registration requirements for tax-exempt status makes the borrowing of capital an unduly burdensome task for municipal governments.[131]

But both sides agree that the precise aggregate impact of a flat tax proposal on municipal bonds remains a mystery.[132]

The Alliance For State and Local Government Finance warns that limitations on tax-exempt bonds endanger the financing of "schools, water and sewer systems, roads, bridges, hospitals and public housing" by states, counties and cities.[133] This coalition also states that further federal cut-backs on revenue distributed to state and local government seriously impede the ability of municipal governments to provide adequate services and facilities and necessitate the imposition of higher state and local taxes.[134]

In a number of areas, the federal government's proposals strike a blow to municipal government operations from both the budget side and the revenue side. Admittedly, municipal governments have more pressing concerns arising from federal budget cutting proposals and the budget deficit itself than from the effects of flat tax reform proposals.[135] Budget plans to eliminate federal revenue sharing with local government, to terminate grants to transit systems (often utilized for municipal busing services), to cut community development block grants, to reduce public housing subsidies, and to sharply cut funds for energy conservation, urban parks, the Job Corps, cultural programs, and waste disposal facilities greatly distress local government administrators.[136]

A Wall Street Journal article notes that "city halls across the country" have name the President's budget plan the "Slasher Budget" and states that "[m]ayors throughout the nation" feel that the proposals of the Administration single out cities to bear the burden of the national deficit.[137]

The Census Bureau reports that the federal government and state governments provided progressively smaller contributions to city government revenue over the last five years.[138] At the same time user charges, interest earnings and utilities provided increasingly larger sources of municipal revenue.[139]

The proposals to disallow deductions for state and local tax actually benefit local governments in areas with lower local taxes on the average (e.g. Florida) by lessening the disproportionately greater federal subsidation of local governments with higher local tax burdens.[140] Conversely, areas with high sales taxes such as New York, Connecticut, California, Tennessee, Illinois, Washington, Hawaii and Louisiana, could suffer from the repeal of sales tax deductions.[141]

In its analysis of the deduction allowed for state and local taxes, the Treasury Department notes that this deduction serves to subsidize a larger proportion of high-income and high-tax states than of low-income and low-tax states.[142] Critics of the deduction of state and local taxes point out that such deductions decrease the progressivity of the federal tax structure.[143] For example, only 2-percent of taxpayers with family income of under $10,000 utilize the state and local tax deduction while 97-percent of individuals with incomes of $200,000 or more benefit from the deduction.[144] Opponents of deductibility also complain that the allowance of a deduction for state and local taxes on sales, real property, personal property and income discourage state and local governments from imposing taxes, ineligible under section 164, which spread costs more equitably to the beneficiary of the facilities or services funded through the general tax funds, such as user fees, special assessments and excises.[145]

## VI. Market Trends

The market anticipates major factors rather than merely reacting after their occurrence because of the sophistication and sensitivity of the municipal bond market.[146] When monitoring market trends, an analyst gains more accurate information by tracking the long-term issues because the short-term municipal issues vary with daily factors.[147] More debt exists in short-term municipals than in the long-term municipals, but longer term tax- exempts are more stable and have higher yields so that they compare more readily with higher yield corporate bonds.[148]

As early as November 19, 1984 the Wall Street Journal published an article advising municipal investors of the potential effect of the flat tax proposals.[149] In this article, Hugh R. Lamle of M.D. Sass Investors Services, states that the proximity of municipal bond yields to the typically higher treasury bond yields results from investor apprehension of a major income tax revision.[150] The opposite view receives support from Richard J. Franke, president of John Nuveen & Co. who attributes the relatively high municipal bond yields to the large supply of municipal bonds on the market, not any anticipation of the enactment of a modified flat tax with lower tax rates.[151]

Since mid-January, some municipal bond market experts observe waivering in the market for long-term municipal issues which these advisors attribute to a fear of the flat tax proposals.[152] Overall, the yields on corporate bonds are moving down more than the yields on long-term tax free bonds for issues of comparable quality.[153] Market forces appear to be narrowing the gap between tax free and corporate[154] or treasury bond issues.[155] The viewpoint that waivering now exists receives additional weight from the recent advent of television advertising for municipal bonds.[156] Even so, considerable disagreement exists over whether the anticipation of flat tax proposals affects the municipal bonds market.

According to other municipal issue experts, the introduction of quasi-flat-tax proposals has no noticeable effect upon the municipal bond market because investors do not expect the proposed withdrawal of the exemption for nongovernmental bonds or a reduction in the tax bracket structure to materialize in their present form.[157] They state that once Congress understands the implications of these tax proposals, it will reject the flat tax programs as economically unsound.[158]

These analysts further assert that even if a flat tax revision goes through Congress, the legislature would first abandon the provisions having major adverse impacts on municipal bonds. If a flat tax proposal is enacted proposals adversely affecting tax-exempt bond obligations are likely to be severely "watered down" through the lobbying efforts of the insurance industry and investment bankers, among others.[159] Some of these municipal bond experts expect any flat tax enacted to contain further limits on the types of bonds eligible for tax exemption but such limits would be prospective only.[160] Thus, while the elimination of IDB's appears feasable, these experts feel that major dislocations of the tax system are unlikely in the near future.

One municipal securities expert notes that a perceived crisis strikes the municipal bond market almost every year.[161] A few years back alarms sounded as the Administration reduced the highest tax bracket from 70-percent to the current 50-percent rate.[162] Furthermore, a 1982 amendment disallows the deduction of 20-percent of interest incurred by depository institutions to carry tax-exempt securities.[163] Another amendment to the Code in 1982 requires the registration of tax-exempt bonds.[164] Then the default of the Washington Public Power Supply System of $2.25 billion of revenue bonds assertedly sounded the death toll for power supply bonds.[165] The Social Security Amendments Act of 1983, requiring the inclusion of tax-exempt bond income in determining whether or not the bond holder pays taxes on Social Security benefits provided another major scare for the market.[166] Yet, through all of these celebrated ends of municipal issues as a major investment alternative, the tax-exempt market continues to provide excellent investment opportunities.[167]

Ronald A. Perlman, assistant secretary for tax policy at the Treasury Department states that the Treasury proposal's restrictions on tax-exempt bonds aim to limit the use of proceeds from tax-exempt bonds "to governments and the activities of governments" and "minimize the extent to which" encouragement of local development is effectuated "through the tax system."[168] However, the Treasury Department's disallowance of the exclusion of IDB interest contradicts President Reagan's assertion that private business is far more efficient than government.[169]

Many vital municipal government projects rely heavily on industrial development bonds to allow local governments to contract out government tasks requiring specialized facilities and expertise.[170] Municipal groups contend that IDB's utilized to finance legitimate government functions contracted out to private enterprise increase the efficiency of the economy rather than cause inefficient transactions performed only for their tax benefits.[171] The Treasury Department states in its report to the President that one of the main objectives of the tax plan is to decrease tax incentives for business decisions.[172] By disallowing the exclusion of interest on IDB's used for municipal purposes by private entities at the direction of municipalities, the new proposals force municipalities to take on the tasks previously contracted out in order to obtain low interest financing and save local tax revenues.[173] Supporters of the DeConcini/Shelby tax reform bill allow all bonds to provide tax-exempt interest, but this approach would also force municipal governments to compete for capital at corporate rates without the advantage formerly bestowed through special tax treatment.[174]

Opponents of industrial development bonds contend that the current tax scheme "bribes" municipal governments to seek private involvement in their projects.[175] One congressional committee staff member comments that private business would sell local officials on paying $15 a ton for waste disposal in a resource-recovery plant (actually costing $30 a ton) rather than paying $10 a ton for local landfill use in order to obtain the $15 a ton tax benefits.[176]

Proponents of industrial development bonds for waste disposal projects point out that energy conservation and environmental issues make the landfill alternative unacceptable, especially in areas where land reasonably available for landfills no longer exists.[177] Resource-recovery plants which burn solid waste to generate power will provide the primary means waste disposal for "cities from New York to Tampa to Tulsa" in future years.[178] The Treasury's plans to deny tax-exempt status to waste disposal IDB's would result in an additional $16 million annually in tip fees alone.[179]

Similarly, the elimination of IDB tax-exempt status altogether would force industries to compete in corporate bond markets in order to fund the non-profit pollution control facilities required under environmental regulation.[180] Proponents of IDB's argue that because society demands pollution control programs and receives their benefits, the federal government should subsidize pollution control facilities by granting tax-exempt status for pollution control IDB's.[181]

The Treasury Department raises a number of valid defenses of its decision to repeal tax-exempt interest on IDB's and other non-government purpose bonds. The Treasury's report notes that the use of non-governmental tax-exempt securities increased rapidly, bringing abuses and placing a heavy burden on federal revenues.[182] In 1975, non-governmental tax-exempt issues accounted for only 30-percent of the municipal market, raising nine billion dollars.[183] By 1983, the year's tax-exempt issues reached $58 billion, comprising 62-percent of the tax-free securities market.[184] The report lists the primary beneficiaries of the tax-exempt status of IDB's as the private businesses or individuals who receive the low interest financing and the affluent bondholders who avoid taxation on their bond income.[185] The detrimental results of IDB financing include: higher financing costs for government purpose bonds due to the large supply of tax-exempt issues on the market; a reduction in federal revenues from uncollected income taxes on bond interest; a corresponding decrease in the funds available for the federal budget; and unequitable advantages of the private parties receiving IDB financing over other private enterprises in the economy.[186] Thus, credible arguments exist both for and against the retention of tax-exempt status for IDB's and other municipal bonds funding home mortgages, student loans, or tax-exempt organizations.

Future interest payments on the federal budget deficit loom darkly on the horizon.[187] Yet practically all of the tax proposals are revenue neutral.[188] In fact, President Reagan emphatically states that he will support only a revenue neutral tax overhaul.[189] The Kemp/Kasten bill falls short of even the current system's revenue raising capacity according to the Treasury Department.[190]

With such major concerns existing over the ability of the federal government to avoid major consequences from a runaway budget deficit, it is surprising that every one of the tax reform plans introduced last fall provide for a substantial reduction in the tax rates.[191] Although the lowering of the tax rates serves as consideration for the drastic reduction in the exclusions, exemptions, deductions, and credits permitted under the code, the degree of the tax reduction for the higher brackets appears unwarranted in light of the financial condition of the United States Government.[192]

The Treasury Department's argument that its proposals should help corporations be able to raise capital more readily by decreasing the bond supply is not well taken due to the Treasury's recent issuance of $11 billion in bonds to cover budget deficit costs.[193] In addition, the Treasury Department recently raised the yield on federal bonds.[194] In view of the mounting federal deficit, the hiking of these interest rates must result from the Treasury's difficulties obtaining debt financing. Interestingly, by removing the tax advantages of IDB's, home owner financing bonds and any other non-government purpose bonds, while concurrently reducing the competitiveness of even general obligation bonds through the reduction in the tax rates, the Treasury Department improves the marketability of its own bonds. Consequently, the Administration could appease the citizenry with lower tax rates while increasing its ability to obtain bond issue financing. Unfortunately, this scheme leaves municipal governments "out in the cold" with regard to the financing of local projects and programs, especially under the Administration's plans to decentralize government by decreasing federal support to state and local governments.

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202-861-6507

October 7, 1985

The Honorable Bob Packwood
Chairman
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

This letter is submitted in connection with hearings held by the Senate Finance Committee on September 24 on tax-exempt bonds. MBA appreciates the opportunity to comment upon the exemption from Federal income tax for interest paid on bonds for multifamily and single family housing and we respectfully request that this letter be included in the hearing record.

The President's tax proposals to the Congress would repeal the exemption from taxation for interest paid on state and local government bonds if more than one percent of the proceeds are used by any person other than a state or local government. Interest on multifamily industrial development bonds (IDBs) and Mortgage Subsidy Bonds, including mortgage credit certificates, would no longer qualify for tax exemption.

The Mortgage Bankers Association of America is a nationwide organization devoted exclusively to the field of mortgage and real estate finance. MBA's membership is comprised of mortgage originators, mortgage investors, and a variety of industry-related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, financing, selling, and servicing real estate investment portfolios.

MBA urges that the Federal income tax exemption on revenue bonds for financing private industrial income-producing facilities be eliminated, except where such financing is used to meet city, state, or Federal environmental requirements, or is used to finance federally or state assisted multifamily housing that is targeted toward meeting the needs of the disadvantaged, specifically the low income, the elderly, and the handicapped.

MBA supports using municipal tax exempt bond issues, and mortgage credit certificates, to provide funds for home mortgages, provided such issues are targeted toward meeting the needs of the disadvantaged. Further, such programs should be simplified and strict standards applied to make them less costly to homeowners and easier to work with for all participants. Moreover, if used, such programs should only be available to housing finance agencies that allow all types of originators and servicers to participate in all their programs.

This country has had an ongoing, longstanding housing goal of decent and suitable housing for all American families. Direct Federal subsidy programs combined with Federal tax incentives were the vehicles that produced new low and moderate-income rental housing at affordable rents. However, budget cutbacks have eliminated direct Federal housing subsidies for new construction. Therefore, current tax incentives to encourage private sector investment in rental housing are the means of fulfilling Federal policy for the production of rental housing for low- and moderate-income households.

The major incentive in the Internal Revenue Code for low- and moderate-income rental housing is tax-exempt financing under Code Section 103(b)(4)(A), which allows state and local governments to issue tax-exempt IDBs for below market-rate financing for low- or moderate-income multifamily rental projects. According to the Wharton study prepared for the Tax Fairness for Housing Coalition, IDB-financed rental housing units as part of all rental housing units started have ranged from 13 to 34 percent during the years 1978 through 1984. In 1984, 23 percent of 492,000 rental housing units started, or 113,000 units, had IDB financing.

It must be remembered that IDB financing encourages private investment in rental housing that would not otherwise be constructed. Investors typically require an after-tax rate of return of approximately 8 percent in order to compensate them for the risks associated with real estate investment. At current market interest rates, the break-even rent, or rent required to provide private investors with a return on investment sufficient to encourage investment in construction, would be in most cases more than low- and moderate-income households can afford to pay. Lower rents would provide rates of return on investments that would be less than investors would be willing to accept in exchange for the risk of investing in rental housing units for low- and moderate-income households. By using tax-exempt financing, investors' costs are reduced, and therefore break-even rents are lower and more affordable by low- and moderate-income households.

The efforts to raise revenues by imposing taxation on certain private activity bonds should not be undertaken at the expense of the 50 year old national policy and the Federal commitment to assist private industry in providing the disadvantaged with decent, safe and sanitary housing. Currently, there are not any alternative means for providing for the economically feasible financing of multifamily housing projects. Previous Congressional mandates have recognized that multifamily housing financed with tax-exempt bonds serves a valid public purpose. The public purpose of a facility should not be defined in terms of who owns it, but rather in terms of who benefits from it. By definition, multifamily housing bonds are not private activity bonds.

The public purpose of multifamily housing was first recognized by the Congress in the National Housing Act of 1934. It was acknowledged by the Congress in the Mortgage Revenue Subsidy Bond Act of 1980 (the "Ullman Bill"), in the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), and in the Deficit Reduction Act of 1984 ("DEFRA"). The Ullman Bill required that 20 percent of the units in multifamily housing projects financed with such bonds be reserved for low income tenants, and required that such projects remain rental for an extended period. In essence, Ullman codified the public purpose of such projects. TEFRA, in exempting multifamily housing from the provisions eliminating the utilization of accelerated means of depreciation, again recognized the public purpose of such projects.

In DEFRA, Congress reaffirmed its recognition of the importance of tax-exempt bonds in financing multifamily residential rental property for the low income when it exempted multifamily housing from the state volume limitation and from the rebate requirement of arbitrage profits applied to IDBs, and when it determined that multifamily housing financed with tax exempt bonds should continue to be eligible for full accelerated cost recovery deductions. Many commercial facilities can bear the increased costs of taxable financing by passing the marginal cost on to the consumer. By definition, the disadvantaged tenant of multifamily housing cannot afford even this incremental cost. The changes proposed by the President's tax proposals will subvert the longstanding public policy of encouraging and protecting housing.

Alternate tax reform proposals prepared by the Joint Committee on Taxation would continue the tax exemption for multifamily housing bonds with revised targeting rules. The state volume limitation as well as IDB arbitrage rebate requirements would be extended to these bonds. MBA supports efforts to make adjustments to the qualifying criteria in order to serve better and target benefits to disadvantaged households. MBA feels the state-by-state volume caps for IDB's proposed in the Bill would have a disproportionate and unfair impact on rental housing. If multifamily housing bonds are not excluded from the volume cap, rental housing will have to compete with large scale economic development projects for financing. Smaller rental housing projects which service the needs of local communities will have to compete on a statewide basis with such large projects to their disadvantage. Limiting that financing will seriously impair the development of the new and rehabilitated rental housing necessary to serve the nation's disadvantaged.

Extending the current IDB investment restrictions and rebate requirements to multifamily housing would serve no public policy purpose. No abuses have been identified under current multifamily arbitrage rules. In addition, it should be pointed out that the developer also assumes the downside risk of arbitrage and that when there is negative arbitrage the developer covers this expense. While the Internal Revenue Service shares arbitrage profits via the rebate procedure, it does not share in the risk and loss associated with negative arbitrage. It is the additional tax features which keep the players in the game.

MBA favors the continuation of tax exemption for interest paid on single family Mortgage Subsidy Bonds (MSBs) provided the proceeds from the sale of these revenue bonds for housing are targetted toward the disadvantaged, that is, low-income families, the elderly, and the handicapped. MBA also believes that all revenue bond programs should allow participation by all types of mortgage originators and servicers.

Mortgage bankers have participated extensively in homeownership programs financed with the proceeds of tax-exempt revenue bonds. When properly administered and properly targetted, revenue bond programs can provide homebuyers with needed financing and mortgage lenders with a new source of business opportunities, without infringing upon markets that can be served without government subsidy.

The Mortgage Subsidy Bond of 1980, TEFRA and DEFRA imposed limitations on MSBs and experience indicates that the use of revenue bonds can be directed to those who cannot be adequately served by the private market.

In extending the MSB program to December 31, 1987, the Joint Committee on Taxation, in its General Explanation of DEFRA, stated that

> "Congress believed that mortgage subsidy bonds can perform a valuable function by enabling first-time homebuyers who might otherwise be unable to purchase a home, because of high interest rates, to do so. When Congress, in 1982, decided to relax certain of the restrictions on mortgage subsidy bonds, the interest rate on taxable mortgages approached 15 percent and the housing market was seriously depressed. Since that time, a significant improvement in the housing market has occurred; however, the typical fixed mortgage interest rate still exceeds 12 percent, and it remains difficult for average Americans (particularly first-time homebuyers) to purchase a residence. In this situation, Congress believed that the qualified mortgage bond program can continue to make an important contribution by making housing more affordable to low- and middle-income Americans."

Because of the rapid increase in the price of financing in 1981 and 1982, the private market was accessible only to a few. Now that home mortgage interest rates have dropped to more affordable levels, the private market is again serving moderate-income homebuyers and a more normal economic environment exists. Tax-exempt revenue bond assistance should be offered only to those disadvantaged people who cannot be served by the private market. If evidence show the states generally do not offer assistance to this group, a careful-adjustment of the Federal law should be made.

MBA appreciates the opportunity to express its views, and would be pleased to furnish any additional information that may be needed.

Sincerely,

STATEMENT OF

HAROLD B. JUDELL

PRESIDENT,

NATIONAL ASSOCIATION OF BOND LAWYERS

PRESENTED TO

COMMITTEE ON FINANCE, UNITED STATES SENATE

IN CONNECTION WITH ITS HEARING ON SEPTEMBER 24, 1985

REGARDING THE IMPACT OF TAX REFORM ON TAX-EXEMPT BONDS

As President of the National Association of Bond Lawyers[1], I would like to comment upon the impact of the Administration's tax reform proposals (Treasury II) on state and local government financing by means of tax-exempt bonds. Our concern is that, in the name of tax reform, fundamental changes in the law affecting local government finance will be enacted without a thorough analysis of their effects.

The Association has a particular responsibility to contribute to an informed debate on Treasury II. Its members are involved in virtually every significant borrowing undertaken by state and local governments in the United States and are familiar with the wide variety of relevant state constitutional and statutory restrictions affecting local government borrowing and affecting the policies of individual states. Members of the Association have seen first-hand how ambiguous provisions in recent federal tax legislation have created problems under existing state laws and resulted in the broadest possible restrictions, some obviously unintended by the drafters of such legislation. Because unintended results can cripple tax-exempt financing and because provisions of Treasury II are so lengthy and complex, many of our members feel that Congress may not comprehend fully the sweeping impact that Treasury II will have on the rights of state and local governments and their ability to raise capital and to carry out their responsibilities in a cost-effective manner.

The Association has produced a set of legal impact papers concerning Treasury II and these are attached to this statement and incorporated into it. The purpose of these legal impact papers is to set forth in clear and simple terms exactly what reasonably can be expected to result if Treasury II is enacted so that Congress can understand what it is being asked to approve.

[1] A non-profit organization composed of more than 2,100 attorneys specializing in public finance.

At the outset, we believe that the proposals have serious constitutional infirmities and, if enacted as contemplated, will unlawfully destroy the ability of states and individual communities to determine and implement their own developmental programs with tax-exempt bonds. Unfortunately, Treasury appears to be promoting, without concern for established constitutional principles, a case which might be termed "The United States Government vs. the Tax-Exempt Bond." Based upon the constitutionally established doctrine of reciprocal immunity between the federal government and state and local governments and the decisions of the Supreme Court upholding this doctrine, it is the position of NABL that without an outright reversal by the Supreme Court of this vital principle, the proposals regarding tax-exempt bonds will be declared unconstitutional. In addition, the proposals contain another significant legal flaw which relates to arbitrage. Under the proposal's arbitrage provisions, state and local governments are required to rebate or pay directly to the federal government income on investments of temporarily idle bond proceeds. This constitutes a direct tax of 100% on a portion of the revenue of state and local governments, a constitutionally impermissible intrusion into the fiscal operations of state and local governments. Therefore, we ask that Congress consider carefully the constitutional issues inherent in the tax reform proposals and only enact legislation written in conformity with the constitutional doctrine of reciprocal immunity and in accordance with the constitutionally mandated separation of powers between the states and the federal government.

Without repeating the detailed information contained in our legal impact papers, I would like to summarize the impact of the proposals on state and local government debt financing.

The proposals set a new and illogical test for determining public purpose based upon "use" instead of purpose. If more than 1% of the bond proceeds are used directly or indirectly by a person other than a state or local government, interest on the bonds becomes taxable. This affects general obligation bonds and revenue bonds issued for governmental facilities and services, as well as those bonds technically classified as industrial development bonds but which finance projects and activities considered by Congress as being of public benefit and purpose, such as:

- Airports, docks and wharves
- Sewage and solid waste disposal facilities
- Air and water pollution control facilities
- Mass commuting facilities and parking facilities
- Local furnishing of electric energy and gas
- Most bonds for single family and multifamily housing (except for publicly-owned housing)
- Convention Halls and functionally related cultural and educational facilities

Under the proposed legislation, ownership or operation of these projects by a governmental agency, authority or non-profit corporation will cause the bonds to become taxable, if such entity does not qualify as a "state or local government." One anomalous result of this could be that a government-owned airport serving only that small part of the population that uses private planes (general aviation) might qualify for tax exemption, but an airport serving the public generally through commercial airlines would not qualify. Another would be that a public school, hospital or courthouse containing a privately-owned cafeteria under a concession contract for more than one year could cause general obligation bonds issued to finance the facility to lose their tax-exempt status. Financing for charitable exempt persons, such as non-profit hospitals, nursing homes, colleges and universities, and special facilities for the aged and disabled, presently qualified under existing law for tax-exempt financing, would be terminated under the new proposals.

The impact of the 1% rule will fall heavily on bonds of a traditional governmental nature, such as those issued for schools, roads, bridges, sewer and water systems, and other components of the infrastructure of our cities and towns. Virtually any private use of these facilities - whether from leasing, management or concession arrangements - could invalidate the tax-exempt status of these bonds.

Another adverse and possibly unintended impact of the 1% rule is to halt a growing trend toward the privatization of public services. This trend is already evident in the financing and operation of water treatment plants, solid waste/resource recovery facilities, and correctional institutions.

The proposals contained in Treasury II will interfere with, and in some cases interdict completely, recent efforts by state and local governments to lower costs, increase management flexibility, and receive performance guarantees for increasingly high-technology services such as resource recovery through public/private sector cooperative enterprises. In this context, the 1% rule seems ill-timed and ill-suited as the arbiter of "public purpose."

On the important question of arbitrage, current Treasury regulations prevent the unlimited "arbitraging" of bond proceeds. Over time these regulations have been extended to prevent the undertaking of tax-exempt issues merely to exploit potential arbitrage investment. However, the regulations, quite appropriately, have contained provisions that, for practical reasons, administrative simplicity and respect for local government rights, permitted certain limited arbitrage investment.

Treasury II would impose on all local government bond issues, no matter what the purpose or how small the issue, the complicated arbitrage reporting and rebate requirements placed last year on "industrial development bonds." Any local government that holds bond proceeds for more than six months would have to comply with these provisions. Treasury II would force local governments to chose between trying to restrict construction timetables for projects to six months or less or face the administrative headaches of complying with the rebate requirements.

Only the largest local government units currently have staffs that could routinely ensure compliance with the proposed requirements. Because of the strict controls on the ability of local governments to appropriate and spend money under state statutes they may also lack even the legal power to make the required payments to the federal government.

Furthermore, the yield on the bond issue under the rebate requirements would be determined without regard to the underwriters' discount, cost of issuance, credit enhancement fees or other costs. The result would be to impose a de facto "negative arbitrage" requirement on local government borrowings. In particular, it would punish the local government that chose to reduce interest costs by a credit enhancement device (such as bond insurance or a letter of credit) when compared to a local government that accepted higher rates in lieu of such approach.

Also, Treasury II would ban all local government "advance refundings," that is, the issuance of bonds to refinance an outstanding bond issue prior to the date on which the outstanding bonds become due or callable. Proceeds of the advanced refunding bonds are deposited with a fiduciary, invested in U.S. Treasury

Bonds or other authorized securities and used to redeem the underlying bonds at maturity or call date and to pay interest on the bonds being refunded or the advanced refunding bonds.

Since purchasers of municipal bonds traditionally require a substantial "no-call" period for bonds to protect against changes in interest rates, advance refundings enable local governments, irrespective of no-call provisions, to take advantage of immediate changes in interest rates to reduce interest costs and to eliminate burdensome bond covenants.

Furthermore, the Treasury has previously removed the "arbitrage" incentive for advance refundings by "yield restrictions" that eliminate all arbitrage profit.

Treasury II's ban on all advance refundings would force each local government to choose either to sell bonds that are redeemable at any time (and thus bear higher rates), or to give the normal no-call protection and lose the opportunity, during the no-call period, of restructuring debt either to reduce rates or eliminate burdensome restrictions.

My last comments relate to the potentially disastrous consequences that the January 1, 1986 effective date embodied in the Treasury proposals will have upon the bond market - consequences that will become even more pronounced if January 1 passes with the tax proposals still on the table. We have consistently opposed assigning an effective date to federal legislation affecting tax-exempt bonds in advance of its enactment by Congress unless there are adequate and appropriate transitional rules to protect projects in progress and permit their completion in an orderly and fiscally responsible manner. The tax reforms of Treasury are designed to enact fundamental and far-reaching changes in the law affecting tax-exempt bonds and not to plug loopholes. Therefore, it is especially important that such wide-ranging laws have proper transitional rules. The proposed legislation does not contain adequate transitional provisions but instead prescribes one inflexible date for radical changes in the treatment of tax-exempt bonds that have not been drafted, let alone considered by the House or the Senate. Such legislation, for all practical purposes, constitutes lawmaking by fiat rather than through the legislative process and is patently inequitable.

As you know, tax-exempt debt cannot be sold without an opinion of recognized bond counsel as to its validity and tax-exempt status. The uncertainty created by any kind of serious threat of retroactive loss of tax exemption would substantially inhibit, if not proscribe, the sale of such debt. Previous uncertainties over legislation introduced but not yet enacted relating to single family mortgage bonds and so-called FSLIC-FDIC bonds attest to this fact. For many months, such bonds were effectively kept out of the market, even though they were perfectly legal at the time.

The proposed January 1, 1986 effective date has already caused many borrowers to assume that they will no longer be able to issue tax-exempt debt after the end of 1985. Consequently, they are rushing towards financings that may be ill-considered and that are likely to unsettle the market significantly by distorting the volume at year end.

A second and more serious consequence is the disruption of the market if January 1, 1986 arrives before Congress has acted upon these proposals.

What will happen is predictable. Experience indicates that at first the market will be almost totally disrupted as investment bankers and bond lawyers representing state and local governments struggle to deal with the uncertainty created by a retroactive date in a way that is acceptable to the bond market. The result will be to penalize those who wish to abide by the law in all respects and who insist on thorough disclosure to the public. The unfairness is obvious, but the scope of it is probably not generally known because Congress so far has not focused on the effects of the proposed legislation. The inequities that result from the presence of a retroactively effective date cannot be persuasively defended and will, we believe, be favored only by those in the Treasury Department who wish to have the current proposals function as de facto legislation until Congress has acted.

We urge Congress to provide adequate and appropriate transitional rules for any legislation affecting tax-exempt bonds.

This statement provides what we believe to be a concise summary of the constitutional infirmities of Treasury II. It also points out the unintended results and potentially harmful effects upon the capital markets, as well as the ability of state and local governments to raise capital for needed projects and services. The effect of Treasury's proposals is to dismantle what has been called one of the best systems ever devised of building the framework of a working economy.

The National Association of Bond Lawyers urges Congress to consider the legal and economic impact of these proposals as though the future of states, towns and cities depended upon it - because it does. The case for tax exemption elimination provided in Treasury's proposals does not justify an end to the doctrine of reciprocal immunity. Nor does it justify the imposition of added fiscal burdens on our states and local governments which will cause an increase in taxes and user fees at the state and local levels.

INCORPORATED BY REFERENCE IN THE
STATEMENT OF HAROLD B. JUDELL

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## TREASURY II TAX PROPOSALS

### Legal Impact Papers

The Administration's current tax proposals ("Treasury II") will severely restrict the ability of state and local governments to finance a wide variety of projects as well as impose additional requirements on those forms of tax-exempt financing that would be allowed to remain. The National Association of Bond Lawyers, a nonprofit organization whose members are involved in virtually every significant borrowing undertaken by state and local governments in the United States, is concerned that, in the name of tax reform, fundamental changes in the law affecting the rights of state and local governments will be enacted without a thorough analysis of their effects.

Members of the Association fear that Congress may not understand the problems that Treasury II's provisions on municipal borrowing will create for state and local governments, problems that may be exacerbated by Treasury II's companion proposals on base tax rates and the deductibility of state and local government taxes. In particular, members and the localities they serve are disturbed that Treasury II treats as "private purpose bonds" a number of undertakings traditionally associated with public purpose, undertakings that will no longer qualify for tax-exempt financing by local governments if Treasury II is enacted.

The Association has produced two Legal Impact Papers on Treasury II. The purpose of these papers is to set forth in clear and simple terms exactly what can be expected to result if Treasury II is enacted so that Congress can understand what it is being asked to approve.

To encourage informed public debate on Treasury II, the Association encourages reproduction, distribution and discussion of the Legal Impact Papers. Copies may be obtained from the Association through its office, P.O. Box 397, Hinsdale, Illinois 60522, Telephone: (312)920-0160.

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Legal Impact Paper

## PUBLIC PURPOSE AND THE ONE-PERCENT TEST

Treasury II lumps together and eliminates as "private purpose" bonds three types of financings that Congress in the past has treated separately -- small issue industrial development, "exempt facility" and "exempt person" bonds. In addition, a wide range of undertakings traditionally regarded as public or public-purpose facilities would be affected. Treasury II defines as "private purpose" any bond, regardless of its purpose, if more than 1% of its proceeds are "used directly or indirectly by any person other than a State or local government." Furthermore, Treasury II indicates that "[g]enerally, use of a facility financed with proceeds of tax-exempt obligations would be considered to be use of those proceeds." "Private purpose" is therefore a ~~serious~~ misnomer, since the definition does not turn on purpose, or even ownership, but use.

The impact of this definition will be deceptively broad. Affected financings range from airport runways to municipal art galleries. The effects include the following:

Public Transportation Facilities. All commercial airport and dock financings will be eliminated, whether such financings are secured by revenues or taxes. This includes runway, clear-zone, air terminal, and hanger financings for airports and channel widening, docks, wharfs, and breakwater or backland financings for harbors and ports. Parking facilities could not be financed to the extent more than 1% of the space would be reserved or held for use by a particular user or class of users. Public transit and commuter facilities, such as bus or rail stations, would have to be both owned and operated by a local government unit, and as described below, ownership or operation by a limited power governmental agency, authority or a non-profit corporation may not be sufficient. One anomalous result could be that a government-owned airport serving only that small part of the population that uses private planes ("general aviation") might qualify for tax-exemption, but an airport serving the public through airlines would not qualify.

Sports, Convention or Trade Show Facilities. These facilities could not be financed if they were owned by or leased to a person other than a local government. Operating, concessionaire, and promoter contracts for a term of more than one year as well as contracts with professional teams may cause the facility to fail to qualify, at least in part, for tax-exempt financing. Even the use by a sports team from a non-profit private college could limit the financing available.

Public Utility Facilities. Governmentally owned and operated sewer, water, storm water, gas and electric facilities would be financeable only if not more than 1% of the output of súch facilities is purchased by a private utility or other non-governmental unit. Assuming the Treasury maintains its current position, take or take-or-pay contracts would cause the facilities to be treated as used by the purchaser of the output. Facilities subject to management contracts or distribution systems to private utilities may be affected. Similarly, governmentally owned and operated solid waste disposal facilities may not be financeable to the extent, for example, steam from the facilities used to generate electricity is sold pursuant to an output contract to a private utility.

Nonprofit Colleges, Hospitals and Other Charities. Because nonprofit colleges, hospitals and other public charities are not local governments, facilities used by such entities could not be financed. In this context, use can arise as a result of a management contract with a term of more than one year. A municipality, for example, could not issue tax-exempt bonds to finance facilities for its zoo, art museum or music center if the facility is operated by a nonprofit corporation or charity.

A separate problem arises for municipal schools or hospitals. If professors or doctors have management or similar contracts with a term of over one year, the municipality could not finance the facilities used by such professionals. A school district employing a caterer to operate its lunchroom could lose its right to finance such facilities.

Urban and Rural Development. Many states have agencies that finance redevelopment of blighted areas, in part, with bonds secured by the proceeds of the additional property taxes generated by their efforts. These agencies in most instances would not be able to issue tax-exempt bonds, even though the bonds are secured by property taxes, because the agencies' most important activity involves assembling and clearing land for use by nongovernmental entities. In addition, more than 1% of the bond proceeds could not be used, for example, to improve store fronts or repaint store walls in a blighted area.

Similarly, the infrastructure of industrial parks could no longer be bond-financed to the extent used by non-exempt persons, unless such use was on the same basis as is the use by the general public. For example, a rail spur used by a railroad and the local business in the industrial park could not be financed.

In more rural areas, irrigation, diking and drainage districts may not be able to finance their facilities unless the farms within the district are treased as the "general public." Flood control districts may confront a similar problem.

Housing. Financing for both multifamily and single family housing would be eliminated.

Governmental Agencies, Authorities and Nonprofit Corporations. Many state and local governments for a variety of valid reasons have formed agencies, authorities and nonprofit corporations to perform various governmental functions, ranging from unemployment counselling to urban development. Facilities or offices used as such entities may not be bond financed unless the entities themselves qualify as local governments. Under the initial Treasury proposal issued prior to the Treasury II, "on-behalf-of" entitites and non-profit corporations controlled by a local government clearly could not issue bonds on behalf of political subdivisions. This provision was omitted from Treasury II, so that the status of such entities is not entirely clear, although it appears that at least some of such entities are intended to be treated like local governments. Clarification is needed to avoid a rather pointless restriction on the ability of states and localities to use special entities to carry out governmental functions.

Loans or Grants to the General Public. The use of bond proceeds to provide student loans and mortgage loans would be prohibited. In addition, bonds for relocation or disaster loans (which are already severely limited by a broad ban on "consumer loan" bonds not yet clarified by regulations) or grants could be further restricted since such loans or grants may not be treated as available to the general public.

Other Government Facilities. Treasury II affects numerous other governmental activities. For example, if a city wishes to build a marina, the financing must be reduced to the extent that the facilities include privately owned or operated fueling, launching or commercial facilities. There is even a question as to whether "boat owners" represent the general public; if they are not, the marina may be considered a "private purpose" facility.

Other prohibited facilities include those that will serve only a limited number of businesses or homeowners and are not parts of a system that serves the general public. Such facilities may include a short breakwater or firebreak to protect only a few homes.

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Finally, if a local government finances an office building, any areas rented to an agency, authority, charity, or even the federal government may not be financed, unless such entity qualifies as a "State or local government." If nonlocal government use increases after the bonds are issued, the bonds' tax-exempt status may be lost.

Other "Exempt Facilities." The current version of Section 103 of the Internal Revenue Code relating to "exempt facilities" is purpose-oriented in that it allows the issuance of tax-exempt bonds for specific facilities that Congress has determined serve a public purpose, regardless of ownership. Treasury II will eliminate tax-exempt financings for all of these facilities, including those for pollution control, sewerage and solid waste disposal and other public purpose "exempt facilities" described above.

Small Issue Industrial Development Bonds. Treasury II will eliminate all such financings, regardless of the priority given to them by local governments and regardless of any state law finding that such facilities serve a public purpose (such as the creation of jobs, revitalization of decayed areas or the increase of the local tax base).

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Legal Impact Paper

## STATE AND LOCAL GOVERNMENTS AND THE ARBITRAGE PROVISIONS

The "arbitrage" provisions in Treasury II will restrict the financing flexibility of state and local governments. In particular Treasury II will limit the ability of every public borrower to invest bond proceeds and in nearly every case will require it either to make direct payments to the federal government or invest bond proceeds in below-market federal securities pursuant to a formula that will result in an actual "arbitrage" loss to the borrower. By eliminating all "advance refundings," Treasury II also will restrict the ability of localities to take advantage of declining interest rates or eliminate burdensome financial covenants contained in outstanding financings.

Current federal tax regulations substantially restrict the ability of local borrowers to make an arbitrage profit, i.e., to invest bond proceeds at an interest rate higher than the rate borne by the bonds because of the differential between taxable and tax-exempt rates. For reasons of practicality, administrative simplicity and respect for local government rights, however, the temporary investment of bond proceeds at a "unrestricted yield" is generally permitted if the local government reasonably expects to spend bond proceeds for a governmental project within three years and proceeds to complete such project with "due diligence." Other existing requirements prevent the use of any "artifice or device" to make arbitrage profits and preclude the premature issuance or overissuance of bonds by local governments.

Rebate and Reporting. Treasury II imposes on all bond issues, no matter what the purpose or how small the issue, the complicated arbitrage reporting and payment requirements in a manner more onerous than was imposed on most private purpose industrial development bonds in 1984. All net earnings, i.e., arbitrage, on the investment of bond proceeds will have to be paid to the federal government. (This payment is referred to in the legislation as a rebate, so none of such earnings were derived from the federal government.) Treasury II does not include the exception that currently permits industrial development bond issuers to avoid the payment requirements if all proceeds are spent within six months. All bond proceeds, without exception, will have to be invested at below market rates or the arbitrage profit will have to be paid to the federal government.

To comply, local governments will have to calculate the amount of bond proceeds invested, the yield on such investment and the yield on the bonds. These calculations can be complicated by the fact that these numbers can vary as frequently as daily, in the case of variable rate bonds and investments. In some cases the locality may not know if a payment is required until long after the investment earnings are spent. Such delayed payments to the federal government may be forbidden under certain state laws if earnings have been spent before the obligation to pay arises, and it is not at all clear in many states that local governments will be legally permitted to make the required payments under any circumstances without major modifications in state law.

Below Market Investments. The proposed rebate calculation will effectively require state and local governments to lose money on investments made with bond proceeds. Not only underwriting fees, cost of bond printing and legal fees but also bank letter of credit fees will be disallowed as expenses of issuance. The result will be both to impose a de facto "negative arbitrage" requirement on local government borrowings and to penalize local governments that choose to reduce interest costs by use of credit enhancements when compared to those that accept higher rates in lieu of such approach.

Temporary Periods and Investment. Treasury II states that all issuers will be required to spend "a significant part" (probably 5%) of bond proceeds within one month of issue and spend all bond proceeds (except for reserve funds) within three years. The first provision could materially limit the ability of local governments to choose the most advantageous time to take their bonds to market. The second provision will substantially restrict and in some cases even preclude the financing of projects with a construction period of more than three years. The most obvious solution, the issuance of a second series of bonds at a later date, will of course involve additional transaction costs. Furthermore this may not be a practical or legal alternative to certain localities because (1) state law may require assurances of available funds before any project can be undertaken, (2) the contractor for such a project may be unwilling, at least without additional compensation, to undertake such project without assurances that adequate funding for completion will be provided and (3) the bond market may reject, or require a high interest rate for, an issue for a project whose successful completion will depend on a second bond issue at a future date (since there could be no assurance that such second issue could be sold at all, much less at interest rates assumed at the time of the original issue).

Treasury II eliminates any temporary period for acquisition projects. Tax revenue and grand anticipation notes do not appear to quality for any temporary period. It is not clear how a municipality will determine which of its general funds must be invested at a restricted yield.

In addition to limiting the temporary periods, Treasury II will also reduce the amount of proceeds that may be invested at an unrestricted yield to 150% of the annual debt service to the extent such amounts do not qualify for a temporary period investment. This provision will be especially difficult to comply with in the case of variable rate transactions because annual debt service would fluctuate from year to year.

The indentures for many bonds permit the issuing municipality to issue additional bonds only if they are parity bonds, i.e., bonds secured on the same terms as the prior bonds. By limiting the amount of a reserve fund to 150% of annual debt service, Treasury II may effectively preclude any parity bonds if an outstanding indenture requires some larger amount of funds to be held in the reserve fund. The proposed limitation cannot be met by restricting yield on the reserve amount in excess of 150% of annual debt service, so the municipality will have no alternative other than a complete refunding of all of its debt, which, as shown below, may also be impossible.

Advance Refunding. Treasury II banned all local government "advance refundings," i.e., the issuance of a second bond issue whose proceeds are used to cancel or "defease" a prior issue by the purchase of investment obligations that secure payment of the original issue. The stated reason for the proposed change is that advance refundings increase the volume of tax-exempt bonds. This is true and is why Treasury regulations have previously removed the arbitrage incentive for advance refundings by local governments by imposing yield restrictions that eliminate arbitrage profits.

Local governments engage in advance refundings for two basic reasons--to realize interest rate savings and to eliminate burdensome restrictions in bond documentation. Purchasers of tax-exempt bonds traditionally require substantial "no-call" protection i.e., a period during which their bonds cannot be redeemed, and the overwhelming majority of fixed rate tax-exempt bond issues now outstanding contain such provisions. If Treasury II were enacted, local governments would be completely unable to refund many outstanding issues for a number of years, no matter how restrictive the existing covenants or how much interest rates decline. Furthermore they will face the unhappy dilemma of having to choose for new issues between either (1) eliminating the no-call protection (and thus paying substantially higher rates) or (2) losing all opportunity during the no-call period to reduce interest costs or eliminate restrictions. A number of practical problems would arise. Changes in regulatory schemes (such as Medicare reimbursement for municipal hospitals) frequently make bond covenants that originally made sense pointlessly burdensome. The ability to respond to these changes will be substantially reduced. Debt and operating restrictions that are either no longer appropriate to the particular issuer or no longer required by the bond market could not be easily eliminated. The ability to take prompt advantage of either an overall reduction in interest rates or an increase in the creditworthiness of the local government (or its revenue producing project) will be substantially eliminated.

Treasury II states that refunding will be permitted only if proceeds of the refunding bonds are used immediately to retire the prior bonds. Even the current ban on advance refundings of industrial development bonds allows refunding within a 180 day period. The results of an immediate refunding rule could be disastrous. A local government could in good conscience plan a refunding on the first day the original bonds could be called and proceed to call such bonds, but in fact might not actually be able to deliver bonds on the call date because of the wide variety of events that can prevent the sale and delivery of bonds on any particular day, such as disruption of the bond market or litigation or other developments that require a delay in the sale in order to ensure compliance with the federal securities laws. In addition, the local government may be unable to give the advance call notice required by the prior bonds because the prior bonds may require that the funds needed to make the call be on hand on the date the notice must be given.

Conclusion. Treasury II goes far beyond preventing the systematic exploitation of the difference between taxable and tax-exempt rates, but severely limits the ability of local governments to make their own financial decisions with a minimum of federal interference. Congress should consider the practical burdens that would be created on local governments by Treasury II's arbitrage proposals, the degree to which legitimate government borrowings will be restricted and whether continuation of the current rules (which already impose substantial restrictions) would have such a negative effect on the federal Treasury as to justify the restrictions and costs that Treasury II's proposals on arbitrage will impose on state and local governments.

STATEMENT BY
Ronald L. Bailey
Chairman of the National Council of State
Agricultural Finance Programs
and
Executive Director of the
Illinois Farm Development Authority

Senate Committee on Finance
September 24, 1985

Mr. Chairman and members of the Senate Committee on Finance. I would like to concentrate my remarks on the effect President Reagan's Tax Reform Plan will have on Agricultural Industrial Development Bonds.

As you know, President Reagan's proposed tax plan will eliminate private purpose industrial development bonds. Agricultural Industrial Development Bonds (Aggie IDBs) are considered small issue private placement bonds and would be eliminated under this tax plan.

I am submitting testimony to you representing the National Council of State Agricultural Finance Programs (NCOSAFP), which represents 16 states who have and are developing agricultural loan programs. Most of these programs are based upon Aggie IDBs.

I also represent the Illinois Farm Development Authority (IFDA), which is the largest state issuer of Aggie IDBs in the nation. To date, the IFDA has approved 1,741 loans for $105,815,000 for applicants through the Young Farmer Program, the Soil Conservation Loan Program and the Agribusiness Loan Program (see attached Program Summary for eligibility requirements - Exhibit I). The average interest rate on an IFDA loan has been 8.75% compared with conventional interest rates of 13% to 15%.

Aggie IDBs are used mainly by young farmers who are getting started in agriculture. The Young Farmer Programs are targeted to the farmer who is purchasing his first substantial piece of real estate and buying machinery, equipment and buildings to get them started in agriculture. We are trying to provide assistance to young farmers to get them started into agriculture.

It is very difficult for a young person to get started into farming and Aggie IDBs are one of the few programs designed to assist young farmers.

We are still seeing the average age of farmers, in Illinois and across the nation, increasing almost on a yearly basis. In Illinois today, the average age of a farmer is 50 years old. The average age of an applicant through the IFDA Young Farmer Program is 31 years old. This shows that we are reaching the target group which Aggie IDBs were intended for - the young farmer.

All states who have Aggie IDB programs today have programs targeted for young farmers. The Tax Reform Act of 1984 outlined the guidelines for uses of Aggie IDBs and set the target group of who could use Aggie IDBs to be young farmers.

To be able to purchase real estate and used depreciable property, the farmer must be able to show that he has never owned more than 15% of the median size farm in the county where the project is located (see Exhibit II). As you can see from this restriction, in Illinois and across the nation, a farmer would be making his first substantial real estate purchase if he were using an Aggie IDB.

The advantages of Aggie IDBs to farmers and rural business is tremendous. The young farmer gets a low interest rate loan which is more affordable to him and easier to cash flow. Most of the lenders who are active in our Illinois program tell me that the difference in the interest rate is what makes the purchase of the real estate or machinery and equipment possible for the farmer.

In Illinois, we feel the farmers we are assisting through the Young Farmer Program will be the backbone of Illinois agriculture some day. These are good young farmers who are obtaining assistance through Aggie IDBs. Out of all of the Young Farmer loans which we have closed, we currently have a delinquency rate of less than ½ of 1%. This shows that we are helping the good young farmer become stable and an asset to his community and the economy in Illinois.

Rural business and agribusinesses benefit tremendously from Aggie IDBs. When a young farmer buys a new piece of equipment from an implement dealer, the dealer makes a profit, the salesman makes a commission, the parts and service departments remain active, the manufacturer makes a profit and the factory worker stays employed. All of these people pay taxes and put money back into the local economy which makes the economy stronger. The Aggie IDBs make this possible by making the equipment affordable to the farmer who starts the whole cycle. This equipment purchase will have a ripple effect on the whole economy. The same would be true of construction of agricultural buildings.

The purchase of real estate is more of a long term stimulation of the economy. If the Aggie IDB makes the real estate affordable to the farmer, that means that the farmer will pay taxes on the land, buy seed, fertilizer, chemicals, fuel, etc., on an annual basis which, once again, helps stimulate the local economy and create and save jobs.

This is not to say that the taxes would not be paid or the farmland would go fallow if it were not purchased by a young farmer with an Aggie IDB, but if the well established existing farmer is the only one who can afford to buy land and expand, we will see the average size of a farm increase tremendously. When you have a few large farmers, they will do business with fewer fertilizer dealers, implement dealers, seed corn salesmen, etc., which will mean fewer jobs in rural America.

Agriculture and agri-related businesses employ 30% of the work force in Illinois. Aggie IDBs have proven to be of tremendous assistance to young farmers in Illinois and Illinois agriculture.

I know that one of the Committee's main concerns, and President Reagan's is the loss in revenue caused by Aggie IDBs (see Exhibit III). We have compiled date from states which have issued Aggie IDBs in the past and this data shows that the approximate loss of revenue to the federal government caused by Aggie IDBs is $5,600,000 annually. This loss in revenue is very minimal when you take into consideration the benefits Aggie IDBs are creating for young farmers in America.

In March, 1985 the IFDA completed a study which analyzes the young farmers who applied for Aggie IDB loans in 1984 (see Exhibit IV). This study produced some very interesting information on the young farmers who are getting Aggie IDB loans, and on lenders who are the purchasers of the Aggie IDBs.

First, the study shows that in Illinois, Aggie IDBs are helping out the target group which they were intended for - the young or beginning farmer.

Second, the study reflects some very interesting data about lenders who purchase Aggie IDBs. The Illinois program, as well as all Aggie IDB programs, is reliant on the private lending institution to purchase a tax-exempt bond for the young farmer. The proceeds from this bond sale are then loaned back to the young farmer at the exact same interest rate and terms as the Aggie IDB.

It is the administration's contention that the purchasers of Aggie IDBs are only the very profitable banks, which creates a bigger tax loss to the federal government. This study shows that to be incorrect.

In 1984, eight Illinois banks purchased 25% of the total bonds which the IFDA approved ($27,500,000). Of these eight banks, four have not paid any federal income taxes for the past 2 years. These four banks are not extremely profitable and do not need the tax exempt income. They are buying Aggie IDBs as a service to their young farmers, and they are trying to help stimulate their local economy through Aggie IDBs. These bankers, as well as others who participate in our programs, feel that they are heldping to stimulate growth in their local economy through Aggie IDBs.

Agriculture is suffering through a very severe crisis, which many economists feel will get worse.

There are very few opportunities in agriculture today, and Aggie IDBs are creating one of the few opportunities available to young farmers. If Aggie IDBs are eliminated, this will serve yet another blow to agriculture.

Mr. Chairman - and members of the Committee - I thank you for allowing me to submit testimony to you and I hope my testimony will be of benefit to you in the major decisions you have before you.

Respectfully Submitted,

Ronald L. B

Ronald L. Bailey
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Executive Director of the Illinois Farm Development Authority

NMHC

NATIONAL MULTI HOUSING COUNCIL

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WRITTEN STATEMENT OF THE

NATIONAL MULTI HOUSING COUNCIL

FOR THE HEARING RECORD OF

THE COMMITTEE ON FINANCE

UNITED STATES SENATE,

SEPTEMBER 24, 1985,

CONCERNING TAX-EXEMPT BONDS FOR THE

PRODUCTION OF RENTAL HOUSING

The National Multi Housing Council is a nationwide organization of over 6,000 members, representing all aspects of the rental housing industry. Together, NMHC members own or operate hundreds of thousands of rental units. Many NMHC members have been active users of industrial development bonds for the production of rental housing.

The President's tax proposals would, among other severe cutbacks in incentives for rental housing, eliminate the tax exemption for interest on all so-called "private purpose" tax-exempt bonds issued after December 31, 1985, including industrial development bonds ("IDBs") for multi-family housing, mortgage revenue bonds ("MRBs") for single-family housing and mortgage credit certificates. The National Multi Housing Council is concerned that, if enacted, this proposal could sharply cut the production of new rental housing, hamper efforts to repair and rehabilitate existing rental stock and place an unfair and disproportionate burden on lower income renters.

Without tax-exempt bond financing, the supply of future rental housing will be substantially reduced, causing rents to increase, because in many cases, tax-exempt financing is the critical factor in making housing development feasible. Without tax-exempt financing -- and without the other tax incentives which the Internal Revenue Code provides -- the typical rental housing project simply does not produce enough income from tenant rents to pay debt service and to provide an adequate return on investment. The reason for the restricted cash flow potential from rental housing is simple: individuals who live in rental housing have limited incomes and, therefore, limited funds available to pay rent. According to the 1983 Annual Housing Survey, the median household income of renters was $12,400 as compared to $24,400 for homeowners. The typical renters spend 25 percent to 40 percent of their income on rent.

Under the model of a typical housing project financed with tax-exempt bonds prepared by the Joint Center for Housing Studies of MIT and Harvard University, a typical tenant would have to pay $319 per month for the development to "break even." If tax-exempt bonds were eliminated, however, this tenant would have to pay $460 per month, and if all provisions of the President's tax reform proposal which eliminate tax incentives for real estate development were enacted, the tenant would have to pay $539 per month. Clearly, many renters cnanot afford the rent levels necessary to support new conventionally-financed rental properties; therefore, developers will not build new units if low-cost,. tax-exempt bond financing is not available. Moreover, if the supply of new rental housing is reduced because of the elimination of tax-exempt financing, rents on existing projects will certainly rise, increasing the financial burden on millions of our citizens, particularly those of lower incomes.

More than 70 million of our citizens rely on the availability of affordable rental housing for their shelter needs. The President's tax reform proposal preserves the mortgage interest deduction for homeowners. This tax benefit increases in value as income levels rise, increasing the tax subsidy to higher income taxpayers. While this recognition of the importance of housing to the American public owning homes is commendable, fairness dictates that the tax code also take into consideration the housing needs of millions of less affluent Americans who depend on rental housing for their shelter needs.

Without tax-exempt bond financing, one NMHC board member has testified that it would expect to cut its production of multi-family housing by at least TWO-THIRDS because these developments will no longer be economically feasible. We believe that many other developers will be forced to do likewise. With these reduced production levels, it is logical to assume that jobs will be lost and unemployment will rise. Materials such as lumber, concrete, shingles, stoves, refrigerators, etc., will not be purchased, which will cause a slowdown in economic activity. Certainly this slowdown will have a negative impact on Federal government revenues. The

Joint Center for Housing of MIT and Harvard University study quantifies these factors and concludes that a slowdown in housing construction would be very detrimental to our economy across the board.

As recent experience demonstrates, tax-exempt financing is an effective tool in the production of rental housing. However, tax-exempt financing merely lowers the mortgage interest rate available to the developer, thus enabling him to reduce rent levels for some or all of the tenants. Unlike a deep subsidy program, such as the so-called "Section 8" program, tax-exempt financing alone cannot produce new rental housing for very low-income tenants. Section 8 combines low-cost financing from either tax-exempt bonds or GNMA tandem with an additional per unit Federal subsidy of $1,500 to $5,000 per year. Thus, it is a mistake to compare what can be accomplished using tax-exempt bond financing alone with what was possible using a combination of low-cost financing and a very expensive deep subsidy.

Nevertheless, tax-exempt bond financing for rental housing has increased the supply of affordable rental housing for a population which by definition is lower income. Over the last three years, the real increase in the cost of rental housing has been only six percent -- less than the real increase in the cost of home ownership -- in part due to the increased use of tax-exempt financing. Finally, it is only when there is a sufficient supply of rental housing that direct Federal subsidy programs such as housing vouchers can operate to permit very low income people to find decent shelter. The National Multi Housing Council believes that tax-exempt bond financing is necessary for the production of affordable housing and, thus, is a very beneficial program for renters. It should not be eliminated.

PROGRAM REQUIREMENTS

To qualify for IDB financing under current law, a residential rental project must set aside 20% of its units (15% in targeted areas) for individuals of low or moderate incomes. For this purpose, the upper limit for low or moderate income qualification is set at 80% of area median gross income. To achieve certain local housing objectives, a number of state and local issuers now impose lower income limits on the 20% of units set aside for low and moderate income tenants. In addition, state and local housing finance agencies require downward income adjustments for one-, two- or three-person households, and the Treasury Department intends to require such adjustments for new IDB-financed projects beginning next year.

Thus, one specific concern -- that the program's set-aside levels for low to moderate income tenants should be targeted more toward individuals of lower incomes than present guidelines allow -- is now being addressed by the Treasury Department. Adjusting tenant incomes for family size significantly reduces the income levels of many eligible tenants (i.e., to 56% of area median for a single tenant) and, thus, significantly increases overall targeting. The National Multi Housing Council has recommended that the forthcoming family-size adjustment be based on apartment size (i.e., "one person" incomes for efficiencies, two person incomes for a one bedroom, etc.) so that developers can reasonably anticipate rent levels in planning a project. This ability to make reasonable projections is essential when dealing with an investment of the magnitude of an apartment building. In addition, developers should be required to set aside the same proportion of 2-bedroom or larger units for low-income families as maintained for market rate tenants in the project as a whole in order to prevent a disproportionate use of smaller units to satisfy targeting requirements. The National Multi Housing Council has consulted with the Treasury Department staff on this issue and has provided them with information concerning the various stages of the inducement and commitment processes, and we will be pleased to provide further assistance to the Congress or to the Treasury Department in order to arrive at a workable solution which satisfies your concerns.

We understand that consideration is now being given to whether other specific program requirements should be directed by Federal legislation or by the state or local government authority. The National Multi Housing Council believes that state and local governmental authorities can guide private housing development to serve and satisfy important local needs most effectively. Under state or local agency supervision, tax-exempt bond financed developments can be tailored according to the particular needs of the region. Thus, authorities can target urban renewal projects to revitalize deteriorating sectors of a city, if necessary, or to require that specific unit types be built; and likewise, authorities can target rural building activity to desired areas, possibly by-passed by other developers. Many housing authorities now address specific regional or local problems through program guidelines. We believe that state or local governmental authorities can guide private housing development to serve and satisfy important local public needs more effectively than the Federal government.

Local market conditions vary greatly. For example, it is sometimes -- but not always -- appropriate to skew project rents, reducing rents for the 20% low income tenants and correspondingly increasing the cost of other units. Contrast the two most active rental housing production markets:

California and Texas. In high land cost areas such as California, relatively expensive "market rent" units are required to support a project and, accordingly, the rents for low-income families must be skewed. However, in other areas where incomes are more stable and land is less scarce, a project can be constructed in which a majority of the units would be affordable for low-income families if no rents are skewed. Rent skewing under such conditions would either result in some low income tenants paying considerably more for their apartments than other tenants with comparable incomes or would make units which would otherwise have been affordable for low income families too costly. Clearly, the state or local authority is in the best position to judge its area needs.

National Multi Housing Council members work closely with state and local authorities in developing IDB-financed rental housing projects, so as to better serve the communities' housing needs. Ultimately, the only alternative to such private sector participation is an increased governmental role, both financially and functionally, in building and operating housing for low and moderate income tenants. The National Multi Housing Council believes that private sector development, under the supervision of a state or local authority, is both more flexible and more efficient than direct government spending.

Thus, tax-exempt financing is a desirable tool in part because it is subject to local control and adaptable to local needs. As the General Accounting Office stated in its June 21, 1985, testimony before the Subcommittee on Oversight of the House Committee on Ways and Means: "Because housing markets differ across the country, it is not possible to precisely quantify at what point more stringent [Federal] criteria would decrease the number of multifamily units that developers are willing to build using tax-exempt bonds."

Despite this recognition of the local nature of housing development, the National Multi Housing Council is aware of the interest of members of the Finance Committee in more stringent targeting of tax-exempt-bond-financed rental housing. At the very least, the National Multi Housing Council believes that any increased federal targeting requirements should be couched in terms of alternatives which can accommodate local conditions and concerns. For example, the present law requirement that percent of the units in a tax-exempt-financed project (15 percent in targeted areas) be set aside for families earning no more than 80 percent of the area median income could be amended to require that either (1) at least 30 percent of the units (25 percent in targeted areas) be set aside for families earning no more than 80 percent of area median income (adjusted for family size except in the case of projects designed for the elderly) or (2) that 20 percent of the units (15 percent in targeted areas) be set aside for families earning no more than 70 percent of area median income adjusted for family size. Further, the family size adjustments to the targeted tenant income limits should be based on apartment size, as noted above, using the greater of area median income or state median income to allow for development in poorer localities such as low-income rural neighborhoods.

CONCLUSION

The national policy served by tax-exempt bond financing of residential property is to encourage the production of sufficient affordable rental housing to meet our housing needs. Tax-exempt bond financing is now the only significant source of low and moderate income housing production. In the absence of any other major Federal housing program, this subsidy is essential to provide the investment return required for developers such as our members to build rental housing. Without tax-exempt bond financing or a comparable incentive, the private sector will not build affordable rental housing; indeed, it will build little rental housing at all.

Any slowdown in multi-family housing production impacts most severely on the lowest income renters because, as rents rise, there is successive displacement with more affluent tenants occupying the available units. Accordingly, regardless of the income levels which are targeted under a rental housing production program, the increased supply of housing serves the needs of the very lowest income renters. This tax incentive is essential if our country is to maintain its commitment to decent and affordable housing.

Statement

of

VIRGINIA MASON HOSPITAL

RE: TAX-EXEMPT BOND PROPOSAL

To Be Included In The Official Records

Of The Tax Reform Hearings Held On

September 24, 1985

By the Senate Finance Committee

The Honorable Robert Packwood, Chairman

September 9, 1985

Virginia Mason Hospital in Seattle, Washington is pleased to submit this statement reflecting deep concerns with certain provisions in the tax reform proposals currently under consideration in Congress. Specifically, we are vitally concerned about the future of tax-exempt bond financing.

For 65 years, Virginia Mason Hospital has been providing health care services to residents of Seattle, the Pacific Northwest and Alaska. Represented within the Medical Center are the Hospital, the Mason Clinic, Virginia Mason Research Center and Virginia Mason Modical Foundation. The Medical Center has also trained over 1,000 physicians, many of whom have remained in the Northwest. Notable among its many achievements has been in recent years the creation and support of a consortium of smaller rural hospitals throughout western Washington. Considerable accomplishments have been made available in health care improvements in these many isolated rural hospitals and the patients they serve through the efforts of Virginia Mason Hospital.

The use of tax-exempt bond financing by not-for-profit has unquestionably grown during the last decade. By 1981, the annual volume of tax-exempt bond issues had reached over $5 billion, reflecting a 19% increase in volume over the previous ten years. While the overall level of capital financing, as indicated by the volume of hospital construction, increased only slightly during the period 1971-1981, the use of tax-exempt financing became the major means of financing such projects. The purposes to which this financing are applied carry significant impacts not only for the entire health care industry but come at a most critical time for Virginia Mason Hospital. We are currently committed to final plans that will allow us to achieve the replacement of our 65-year-old facility and prepare for meeting the Medical Center's future needs. Based on current architectural plans and estimates, we foresee total capital requirements in the range of $45-65 million. The accomplishment of this commitment to continuing service assumes the availability of tax-exempt revenue bond financing. Based on historical differences in interest expense between taxable and non-taxable rates, we project an interest expense savings approaching $25 million. With 45% of our patients being served under the Medicare Prospective Payment System program, this represents a considerable savings to the federal government and its taxpayers.

For the second time in as many years, however, not-for-profit hospitals are facing a serious challenge to the availability of these tax-exempt financing instruments. Having won the earlier battles by convincing Congress of the public policy value in continuation of this favorable tax treatment, we now face an even graver threat.

One of the most cogent arguments for the retention of tax-exempt bond financing revolves around the changing circumstances of Federal health care policy. In 1981, the Reagan Administration obtained enactment of the Prospective Payment System ("PPS"), which dramatically altered the way hospitals were reimbursed for Medicare services. This new system has produced dramatic results in terms of curtailing the rate of increases for Medicare expenditures with renewed optimism for protecting the solvency of the Medicare program into the late 1990s.

Although a capital pass-through is provided in the retrospective reimbursement for capital costs, Congress has already begun to look at some of the collateral issues relating to the costs of capital under Medicare. As 1986 approaches, this Congressional focus will increase, and change can be expected. Inevitably, such change will reduce the amounts of capital recovered through Medicare. The day of unlimited capital reimbursement through Medicare is coming to a rapid close.

Whatever the limitations placed on hospital capital recovery are, they are certain to further exacerbate the budgetary constrictions already faced by not-for-profit hospitals. While the voluntary hospital community continues to support and produce impressive records in containing national health care costs, the elimination of tax-exempt bonds in the face of PPS presents a very dire situation, indeed. Moreover, the issue of capital recovery is not the only issue on the agenda of Federal health care policy makers. Freezing Medicare payments, reducing payments for medical education and cutting Medicaid eligibility are further examples of the kind of policy options now under consideration by the Congress and the Administration that would bear heavily on not-for-profit institutions. As these additional concepts become translated into public policy, it becomes increasingly important to preserve tax-exempt bond financing and protect the voluntary hospitals which, in particular, are severely affected by these new policy directions. Concerning the needs of providing care to the medically indigent under the overall category of "uncompensated care," Virginia Mason Hospital's record has been one of responsibility to the community it serves. The rate of increase in Virginia Mason's commitments to funding uncompensated care has grown rapidly over the past three years as shown below:

| | |
|---|---|
| 1985: | $1,120,000 |
| 1984: | $1,002,000 |
| 1983: | $ 942,000 |

While the new directions of PPS would impose onerous financial restrictions on the not-for-profit health care provider, this same kind of institution is caught at another competitive disadvantage in comparison with the for-profit hospital. Inasmuch as voluntary hospitals do not receive a return on equity and are not eligible to enter equity markets, it follows that the loss of tax-exempt funding for capital projects, including equipment, new technology and renovation will leave them stranded in the marketplace.

The issue of elimination of tax-exempt bond financing must also be reviewed within the context of the overall tax reform plan. The "Treasury II" proposal, in particular, contains a number of other proposals that would adversely affect not-for-profit institutions. Elimination of the charitable deduction for non-itemizers would reduce the money that voluntary hospitals have available for "public purposes." Employers may well be encouraged to drop or reduce their health benefits as a result of the proposal to tax employer paid health benefits thus aggravating the already serious problem of uncompensated care which already falls heavily on the back of the not-for-profit institution. State and local governments which have historically been strong allies of the not-for-profit hospital community, will find it more difficult to meet their responsibilities for Medicaid and other programs for the indigent as a result of the elimination of the deductibility of state and local taxes. Such discussion and cutbacks have been the focus of health care policy development in the Washington State Legislature for the past two years.

Finally, the unique role of the not-for-profit hospital must be recognized. Not-for-profit hospitals are not merely public purpose entities, they almost single-handedly meet the critically important health needs of the communities they serve. Through research, education, and care for the uninsured and indigent (all ingredients represented at the Virginia Mason Medical Center), hospitals make a vital contribution to the overall social good. This must be considered when the question of using the tax code for social policy is evaluated. Clearly, the use of tax incentives for social policy objectives will not disappear with the latest effort to reform the IRS code. The not-for-profit hospitals, then, must not be required to shoulder an undue portion of the reform burden.

YMCA of the USA
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Solon B. Cousins
Executive Director

(312) 269-0530

September 30, 1985

The Honorable Bob Packwood
Chairman, Senate Finance Committee
219 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Packwood:

We appreciate your careful attention, in last week's hearing on tax-exempt bonds, to the potential effects of the Administration's proposal to eliminate charitable organizations' eligibility for tax-exempt financing. The YMCA of the USA strongly opposes the proposal.

YMCAs clearly do serve public purposes -- and reduce the need for costly alternative government services -- not only in health and fitness, but in child care, in housing and nutrition for the elderly, in youth employment and training, and in many other areas. YMCAs and similar organizations respond to community needs, and units of government issue tax-exempt bonds for such organizations because they know the value to the community of the many programs such organizations provide.

The YMCA of the USA's Executive Committee adopted the enclosed statement on tax-exempt financing by unanimous vote. We especially point out, "Tax-exempt bonds are often the only feasible means of financing new YMCA facilities, college dormitories, community hospitals, and other much-needed community service facilities." The proposed lowering of tax rates is expected to reduce charitable contributions substantially. We urge that charities not be further hampered by additional burdens such as the loss of this resource.

We appreciate your including this statement in the hearing record.

Sincerely,

Solon B. Cousins
Executive Director

SBC/cl
Attach.

## PRESERVING TAX-EXEMPT FINANCING FOR CHARITABLE ORGANIZATIONS

Problem: The President's tax reform proposal would deny state and local governments the authority, granted by current law, to issue tax-exempt bonds for the benefit of YMCAs and other tax-exempt charitable organizations.

Solution: Retain tax-exempt financing for public purpose activities of charitable organizations as under current law.

Discussion: While the Internal Revenue Code has long restricted the rights of state and local governments to issue tax-exempt bonds for private nongovernmental purposes, current law treats tax-exempt bonds for the benefit of charities as essentially equivalent to bonds issued for purely governmental purposes. Underlying this rule is Congress' recognition that charitable organizations serve public, not private, purposes, and often meet needs that would otherwise fall on government.

The President's tax reform proposal would reverse this long-standing policy by limiting tax-exempt financing to projects used exclusively by governmental entities. The principal rationale advanced is that the growth in nongovernmental tax-exempt bonds has raised the interest rate state and local governments must pay to finance public projects and, at the same time, provided an unjustified tax benefit to high-income investors.

While this may be a compelling justification for eliminating tax-exempt financing for private projects like factories or warehouses, it does not justify denying tax-exempt financing for charities. Congress' past judgment remains valid -- charities, like state and local governments, do serve public purposes and often directly reduce the demand for government services. Further, charities account for only about 13% of all tax-exempt bonds. Therefore, retaining tax-exempt financing for public purpose activities of charities would not significantly increase the interest rate state and local governments must pay to finance public projects.

Tax-exempt bonds are often the only feasible means of financing new YMCA facilities, college dormitories, community hospitals, and other much-needed community service facilities. Thus, eliminating this funding source would significantly impair the ability of these vital charitable organizations to continue to serve the public. Moreover, unlike individuals and businesses who would lose some current tax benefits under the President's proposal, charities will receive no compensating advantage from lower tax rates. On the contrary, these lower rates, by reducing the tax incentive for charitable giving, will substantially reduce charitable contributions. In short, charities will be net losers under the President's plan quite apart from the proposed elimination of tax-exempt financing. This harm should not be compounded.

YMCA of the USA
September 1985