United States General Accounting Office

GAO

Report to the Chairman, Human Resources and Intergovernmental Relations Subcommittee, Committee on Government Operations, House of Representatives

April 1993

INDUSTRIAL DEVELOPMENT BONDS

Achievement of Public Benefits Is Unclear

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General Accounting Office
Washington, D.C. 20548

Resources, Community, and
Economic Development Division

B-249447

April 22, 1993

The Honorable Edolphus Towns
Chairman, Human Resources and
Intergovernmental Relations Subcommittee
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

In response to the request of the late Chairman, this report presents the results of our review of the use and benefits of small issue industrial development bonds for manufacturing. The report contains a matter for consideration by the Congress about the extension of the provision authorizing the bonds.

As arranged with your office, unless you publicly announce its contents earlier, we will make no further distribution of this report until 30 days after the date of this letter. At that time, we will send copies to the Secretary of the Treasury; the Director, Office of Management and Budget; and other interested parties. We will make copies available to others upon request.

This work was performed under the direction of Judy A. England-Joseph, Director, Housing and Community Development Issues, who can be reached on (202) 512-7631 if you or your staff have any questions. Major contributors to this report are listed in appendix II.

Sincerely yours,

J. Dexter Peach
Assistant Comptroller General

Executive Summary

Purpose

The federal government forgoes revenue, estimated by the Joint Committee on Taxation at over $2 billion in 1991, because of the tax-exempt status of small issue industrial development bonds (IDB). The bonds, issued by state and local governmental authorities, are intended to help finance the creation or expansion of manufacturing facilities. Because these bonds are considered to generate public benefits, the Internal Revenue Code (IRC) exempts the interest investors earn on the bonds from federal income taxes.

Because of concerns about what the nation receives in return for the forgone tax revenue on IDBs, the Chairman of the Human Resources and Intergovernmental Relations Subcommittee, House Committee on Government Operations, requested that GAO determine (1) what public benefits are achieved through the use of IDBs; (2) the extent to which IDBs are subject to default; and (3) the extent to which IDBs are paid off early, thus removing IRC use restrictions so that the projects could subsequently be used for purposes other than manufacturing.

Background

The interest earned on certain bonds used by private entities is tax-exempt because the activities financed are considered to produce public benefits. These "private activity bonds" are issued by state and local governmental authorities who provide the proceeds to private entities to finance, among other things, student loans, mortgages, and manufacturing projects. Private activity bonds that are issued to finance manufacturing projects are commonly referred to as IDBs, although the IRC refers to them as "qualified small issue bonds."

Because of concern that some private activity bonds were being used primarily to benefit individuals and not the public, the Congress in recent years has passed several laws to restrict private activity bond use. For example, a 1984 law prohibited the use of private activity bonds to finance facilities such as health clubs, liquor stores, and gambling establishments. The federal requirements for IDBs, which have evolved from this series of laws, required that 95 percent of the proceeds from each bond be used to finance manufacturing facilities, such as machinery, equipment, or buildings. The law also limited the dollar amount of an individual bond issuance to $10 million or less.

The process of issuing an IDB is administered by the state or local bond issuer. Applications for IDB financing are accepted, reviewed, and approved by these public authorities. Once the bond is issued, the proceeds are provided to the developer, generally through a trustee, who may approve the developer's expenditures and ensure that they are consistent with project requirements.

Although the IRC authorization for issuing IDBS expired on June 30, 1992, the President has proposed extending the IDB provision permanently. According to an estimate by the Joint Committee on Taxation, such an extension would result in an additional $230 million in forgone tax revenue over the first 5 years.

Results in Brief

GAO's work indicates that IDBS are being used for their intended purpose of financing manufacturing facilities. However, while proponents of the bonds claim that IDBS achieve additional public benefits, such as creating jobs, assisting economically distressed areas, fostering start-up companies, and keeping manufacturing firms in the country, GAO found that it was unclear whether IDBS significantly achieve these benefits. Specifically, GAO's 50-state survey showed that state and local issuers generally have not established requirements to direct IDBS toward achieving these benefits. Furthermore, GAO's review of three states that accounted for about 20 percent of total 1991 IDB issuance, shows that achievement of the benefits claimed for IDBS was limited. Of the 68 projects financed with IDBS in 1991 in those states, only 16 of the projects were located in economically distressed areas, only 7 projects involved start-up companies, and only 1 project might have moved to another country had it not received IDB financing. The job creation benefits attributed to IDBS would likely have occurred anyway. Sixty percent of the developers from these projects stated that they would have done their projects without IDBS, although about half of these developers said that their projects would have been scaled down. However, even for the projects that would have been scaled down or cancelled without IDBS, the money not spent on the projects would have been used elsewhere in the economy, also creating jobs. Because IDB use is generally not focused on public benefits and GAO's work in the three high-volume states shows limited achievement of public benefits, GAO questions whether the benefits provided by IDBS are worth the tax revenue forgone.

Additional concerns that IDBS are subject to high rates of default or that IDBS are paid off early, thus removing IRC restrictions requiring the project to remain in manufacturing, are not borne out by GAO's work. In the three states GAO reviewed, IDBS seldom defaulted, which may be attributable to safeguards in the issuance process to ensure that the developers are creditworthy and that the projects are sound financially. Similarly, few IDBs were paid off early, and GAO found no evidence that projects were subsequently used for nonmanufacturing purposes. When early payment of the IDB occurred, usually the company refinanced the debt or had become financially able to pay it off.

Principal Findings

Achievement of Public Benefits From IDBs Is Questionable

While IDBs meet the requirements of the IRC—that they be used to finance manufacturing projects—it is questionable whether, as claimed by IDB proponents, they significantly achieve other public benefits. IDB proponents, such as state economic development authorities, credit IDBs with creating jobs, assisting start-up companies, helping economically distressed areas, and keeping companies from moving operations to foreign countries. However, the IRC has not required that such benefits be achieved, nor has it required that state or local issuers develop criteria for achieving such benefits. According to GAO's questionnaire to all states, nearly three-quarters of them—37 in 1991—did not impose public benefit requirements beyond those contained in the IRC; instead, they issued bonds to qualified projects on a first-come, first-served basis. In more than half the states—30 in 1991—localities issued part of the state's IDBs, but available information indicates that many, if not most, local issuers did not have additional public benefit criteria for IDB issuance.

In the three high-volume states we reviewed—Ohio, Indiana, and New Jersey—the 68 projects financed with IDBs in 1991 achieved some limited public benefits, but the job creation attributed to the projects would likely have occurred without IDBs. According to the developers, 60 percent of the projects would have been done in the absence of IDBs, either as essentially the same project or as a scaled-down project. The remaining 40 percent of the projects would have been cancelled, according to the developers. The resulting job impact, as estimated by the developers, is that of the 3,500 new jobs they said their projects would create, about 1,700 jobs would have been created in any event. About 1,800 jobs would not have been created because of project scale-downs or cancellations, according to the developers. However, the 1,800 jobs may not represent net job creation, because this estimate does not take into account that, for projects that would have been scaled down or cancelled without IDBs, the money not spent on those projects would have been used elsewhere in the economy, which would also create jobs.

Besides job creation, GAO found limited achievement of other public benefits attributed to IDB financing in the three states reviewed. For 68 IDB projects in these states, only 7 involved start-up companies, only 16 were located in high-unemployment areas, and only 1 might have relocated to another country if IDB financing were not available. The companies benefitting from the lower cost of capital that IDBs provide were generally well-established, having been in business 33 years on average and having annual sales averaging $27 million.

IDBs Seldom Default, and IDB Projects Remain in Manufacturing Use

A high rate of default for IDBs would raise concern that the federal government had forgone tax revenue for IDB issuance only to have the projects fail and thereby lose much of the public benefits they might have produced. Similar concerns would be raised if many IDBs were paid off early, thus removing IRC use restrictions so that the projects could subsequently be used for purposes other than manufacturing. However, of the 523 IDBs issued between 1987 and 1991 in the three states GAO reviewed, only 4 defaulted and only 20 were paid off early. For the IDBs that were paid off early, available information indicates that all the projects continue to be used as manufacturing facilities.

The low rate of default for IDBs may be attributable to (1) state and local issuer safeguards to ensure that the project developer is creditworthy and (2) project reviews by underwriters and lawyers to ensure that the project is financially and legally sound. In the three states that GAO reviewed, the early payment of IDBs was usually attributable to the developer's refinancing the bond at a more favorable interest rate or becoming financially able to pay off the bond.

Matter for Congressional Consideration

Given the questions that surround whether IDBs are achieving the public benefits attributed to them and in view of the tax revenue forgone, the Congress may wish to consider not renewing the IDB provision. If, however, the Congress should act to extend the provision, it may wish to specify requirements to better direct IDBs toward achieving public benefits that would not occur from alternative investment of the money. For example, the Congress may wish to provide requirements that would direct IDBs to economically distressed areas or to start-up companies.

Agency Comments

GAO discussed the information presented in this report with the Director, Office of Tax Analysis, and other officials of the Department of the Treasury, who generally concurred with the facts. GAO also discussed the contents of the report with officials from the three states GAO reviewed, who generally agreed with the facts presented about their states but strongly believe that IDBS created jobs in their states. GAO believes that, because 60 percent of the developers—beneficiaries of IDBS—said that they would have done essentially the same project or a scaled-down project without IDBS, much of the job creation associated with the projects in these states cannot be attributed to IDBS. Moreover, where projects would have been scaled down or cancelled without IDBS, the money not spent on those projects would have been used elsewhere in the economy, also creating jobs for the nation as a whole, although not necessarily in these three states. As requested, GAO did not obtain written agency comments on a draft of this report.

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Abbreviations

GAO	General Accounting Office
IDB	Industrial Development Bond
IRC	Internal Revenue Code
PAB	Private Activity Bond

Introduction

The Internal Revenue Code (IRC) has provided authority to state and local governments to issue tax-exempt bonds for use by private entities to help provide financing for small manufacturing projects. Because the Congress intended that these bonds—known as small issue industrial development bonds, or IDBs—would in some manner benefit the public, investors pay no federal taxes on the interest earned from IDBs.[1] As a result, the federal government currently forgoes over $2 billion in revenue annually for all cumulative outstanding IDBs, according to the Joint Committee on Taxation. Although the authority to issue new IDBs expired on June 30, 1992, the President has proposed a permanent extension of the IDB provision. According to an estimate by the Joint Committee on Taxation, extending the provision would cost about $230 million in tax revenue over the first 5 years of the extension.

For purposes of this report, IDBs refer to small issue industrial development bonds, designated in the IRC as "qualified small issue bonds," which cannot exceed an issuance amount of $10 million and are used to finance manufacturing projects.

Overview of Tax-Exempt Bonds

The IRC has long allowed state and local governments to issue bonds whose interest payments are exempt from federal income tax. As a result, governmental authorities can finance projects at lower costs because investors are willing to accept lower interest rates on their investments in return for tax-exempt income. Issuers can then use tax-exempt bonds to finance public projects, such as schools, roads, and water and sewer facilities.

In addition to issuing bonds for use by governmental authorities, the IRC permitted tax-exempt bonds to be issued by state and local governments for use by private entities, provided the bonds are used for certain specified activities. Known as qualified private activity bonds (PAB), they can be used to provide financing for, among other things, student loans, mortgage loans, and manufacturing projects. PABs issued to finance manufacturing projects are referred to as small issue industrial development bonds.

[1] Earnings on IDBs may be subject to the capital gains tax or to the alternative minimum tax, depending on the taxpayer's individual circumstances.

Legislative Restrictions Define Public Purpose for Private Activity Bonds

Concerned about the types of activities that were being financed with PABs and wishing to limit the amount of tax revenue forgone in permitting them, the Congress passed a series of laws to better focus the use of these bonds on activities that benefit the public and to restrict the aggregate dollar volume of PABs that can be issued.

For example, in 1984 the Deficit Reduction Act generally prohibited tax-exempt bond financing for the purchase of existing buildings and also eliminated tax-exempt financing for airplanes and for facilities such as health clubs, liquor stores, and gambling establishments. The 1984 act also required that small issue IDBs be used only for manufacturing facilities after 1986. The Tax Reform Act of 1986 continued this legislative direction, eliminating the tax-exempt status of financing for such projects as sports facilities, convention and trade show facilities, and parking facilities.

The Tax Reform Act of 1986 also implemented the Congress' decision to restrict not only the types of activities that could be financed with PABs, but also the total amount of these bonds that could be issued each year. This law imposed an issuance limit, known as a volume cap, that restricts the amount of private activity bonds a state may annually issue to the greater of $50 per state resident or $150 million per state. Within the PAB volume cap, the states may decide what types of eligible activities best serve the public and should, therefore, receive a portion of the limited amount of private activity bond financing. The legislative restrictions imposed on PABs have reduced their proportional representation among the total amount of tax-free bonds issued from 33 percent of the total of tax-exempt bonds issued in 1985 to about 23 percent in 1990.

The IDB for manufacturing evolved from this series of legislative actions to remain a PAB eligible for tax exemption that is included among those bonds that are subject to the state volume cap restrictions. The amount of IDBs issued increased in the late 1980s but has since begun to decrease. IDB volume grew from $1.2 billion in 1987 to $1.9 billion in 1988 to $3.1 billion in 1989, when it began to decrease to $2 billion in 1990 and to $1.1 billion in 1991.[2] Because the bonds typically have long terms, despite the recent decreases in annual IDB volume, as of June 30, 1992 (the most recent date for which information is available), the cumulative amount of outstanding

[2]To provide 5-year trend information on IDB volume, data had to be gathered from several different sources. The Department of the Treasury was able to provide data on IDB volume for 1987, 1988, and 1989 but had no more recent information. Therefore, we used data gathered by the Advisory Commission on Intergovernmental Relations to provide IDB volume for 1990 and our own work to provide IDB volume for 1991.

IDBs for manufacturing is still significant, totaling approximately $113 billion, according to the Federal Reserve Board flow of funds.

Federal, State, and Local Issuance Requirements for IDBs

The federal requirements for the use of IDBs are specified in section 144(a) of the IRC. IDBs are to be used to finance the building or expansion of small manufacturing projects. Specifically, the section requires that 95 percent of the net bond proceeds be used to finance manufacturing facilities or equipment and that the amount of a single bond cannot exceed $10 million.[3] The IRC also limits the firms eligible to use IDBs over $1 million to those meeting certain capital expenditure requirements. That is, the combined amount of the firm's IDB and related capital expenditures in any one municipality cannot exceed $10 million over a 6-year period. Furthermore, the IRC limits the amount of debt that a firm may have outstanding from multiple IDB issuances to a combined total of $40 million during an initial 3-year period.

Some states have chosen to establish additional issuance criteria specifying the public benefits that the bonds are expected to achieve—such as creating jobs, assisting start-up companies, providing aid to economically distressed areas, and keeping manufacturing companies from moving their operations to foreign countries. Proponents of IDBs, such as state economic development authorities, claim that these are the kinds of benefits that IDBs produce.

The IRC allows, but does not require, states to delegate some or all of their volume cap authority for issuing private activity bonds—including IDBs—to localities. These local issuers must comply with the basic federal requirements for IDB issuance and any additional state requirements. Local issuers may also establish additional issuance requirements for public benefits—such as job creation—and may also require the project to comply with community planning or zoning requirements.

Process for Issuing IDBs

Various governmental and nongovernmental parties are involved in issuing IDBs. These parties include the state and local governments and various professionals who have a role in the process of ensuring that IDBs meet issuance and repayment requirements.

[3]First-time farmers could also use IDBs not exceeding $250,000 to acquire land for farming purposes. However, this is a minor use of the provision and, accordingly, we have excluded this use from our report.

One of the major roles of the state in the issuance process is to control the allocation of the volume cap for PABs, including IDBs. In controlling the volume cap, the state determines (1) what portion of its volume cap, if any, will be allocated to local issuers and (2) the amount of funding each eligible PAB activity will receive. Some states retain control of the volume cap in the governor's office, while others place this responsibility in a state office, such as the department responsible for commerce, economic, or community development. The state agency responsible for administering the volume cap may also prepare reports on its activities for the governor and state legislature.

For state-issued bonds, typically the state accepts applications from developers interested in receiving IDB financing. The state reviews the application to see that it meets applicable federal and state requirements and determines whether or not to approve the application for IDB financing.

When a local issuer is involved, typically the locality accepts the developer's application for IDB financing and reviews it for compliance with federal and any state or local requirements. The locality generally receives or requests volume cap allocation for the project from the state. Some states also require the locality to submit the IDB application to the state for a review of its merits.

In the process of issuing an IDB, the state or local issuer would involve the services of several private professionals. For example, lawyers, known as bond counsel, are employed to advise the issuer as to whether the project meets all legal requirements. Financial groups, such as investment syndicates, often facilitate the marketing of the bonds by purchasing them and subsequently selling them to investors. Banks are often employed to provide repayment guarantees for the bonds and to control the disbursement of the bond proceeds. All of these participants in the IDB issuance and repayment process receive fees that ultimately become part of the cost of issuing IDBs, although these costs are limited to 2 percent of the bond proceeds.

Once the bond has gone through the application, review, and issuance process, the proceeds are then provided to the developer, often through a trustee, who generally approves the developer's expenditures and ensures that they are consistent with project requirements. However, when the bond is paid off in full, all use restrictions are removed, which could allow the projects to subsequently be used for purposes other than manufacturing.

Objectives, Scope, and Methodology

The Chairman, Human Resources and Intergovernmental Relations Subcommittee, House Committee on Government Operations, requested that we assess the use and impact of small issue manufacturing IDBS, particularly with respect to the public benefits achieved. As agreed with the Subcommittee's office, our objectives were to determine (1) what public benefits are achieved through the use of small issue IDBS; (2) the extent to which IDBS are subject to default; and (3) the extent to which IDBS are paid off early.

To determine the public benefits achieved through the use of IDBS, we first ascertained what federal, state, and local requirements are in place to direct IDB use. We reviewed legislation and the supporting legislative history to identify federal requirements for the use of IDBS. We then administered a 50-state questionnaire to determine what additional requirements state and local issuers have established to direct the use and benefits of IDBS. The questionnaire also provided information on the volume of IDBS each state issued in 1991. We selected IDBS issued in 1991 because the data on these bonds were the most recent available. We also discussed the benefits of IDBS with officials from the Congressional Research Service and the Council of Industrial Development Bond Issuers. We interviewed Department of the Treasury and Internal Revenue Service officials to determine their role in the IDB issuance process and what current information is available on IDB use.

We performed detailed work in three states—Ohio, Indiana, and New Jersey—having a high dollar volume of IDBS in 1991 and together representing about 20 percent of the total amount of IDBS issued that year. While the results from these states are not projectable to the nation, our work provides detailed information on how a significant portion of IDBS issued in 1991 were used. To obtain standardized information in these states, we developed a structured questionnaire and gathered data on IDB requirements and benefits from state officials responsible for IDBS, state and local IDB issuers, and developers who used IDBS. We were able to obtain questionnaire responses from 66 out of the 69 companies that received IDBS in these three states in 1991. To determine why IDB volume was relatively low in some states, we contacted officials from five states. We selected these states because they had used a small percentage of their volume cap for IDBS, yet the states' total new capital expenditures for manufacturing were relatively high. We made this comparison for 1990—the latest year for which information was available on capital expenditures.

To address the second and third objectives, we gathered information on all IDBs issued, the number defaulted, and the number paid off early in the three states reviewed—Ohio, Indiana, and New Jersey—for the period from 1987 through 1991. We selected this period to limit the bonds we reviewed to those issued after the 1986 legislative restrictions. To obtain data on the circumstances surrounding the default and prepayment of IDBs, we interviewed cognizant state and local officials responsible for administering and issuing IDBs, such as state department of development directors and local economic development authority directors, and gathered applicable documentation, where available.

We performed our audit work in Washington, D.C.; Columbus, Ohio; Indianapolis, Indiana; and Trenton, New Jersey, and provided preliminary results of our work to the Chairman on July 24, 1992.[4]

This review was conducted from December 1991 through December 1992 in accordance with generally accepted government auditing standards. Major contributors to this report are listed in appendix II.

[4] Industrial Development Bonds (GAO/RCED-92-247R, July 24, 1992).

Achievement of Public Benefits From IDBs Is Unclear

While IDBs are being used for their intended purpose of financing small manufacturing projects, it is unclear whether IDBs are significantly accomplishing for the nation the public benefits attributed to them by their proponents. IDBs are credited with achieving public benefits, such as creating jobs, assisting start-up companies, providing aid to economically distressed areas, and keeping manufacturing companies from moving their operations to foreign countries. These benefits, however, were not required by the IRC, and most state and local issuers have not focused IDB financing on achieving these public benefits. IDB-financed projects we reviewed in three states achieved some of these benefits to a limited extent. However, the job creation benefits attributed to these projects would likely have occurred without IDBs, because either the same or alternative projects would have been financed privately.

IDBs Were Used for Eligible Purpose

Our review of IDBs issued in 1991 in three states—Ohio, Indiana, and New Jersey—showed that all the bonds were used to finance activities that are eligible under the IRC. The IRC requires that IDBs be used to finance manufacturing facilities and that the bond issuance amount be under $10 million. Of the total dollar amount of IDBs issued in these three states (about $223 million), the funding was apportioned as follows:

- About 28 percent funded the construction of manufacturing facilities.
- About 15 percent funded the purchase and rehabilitation of manufacturing facilities.
- About 43 percent funded the purchase of machinery and equipment.
- About 9 percent funded other related purposes.[1]

Also in compliance with the IRC, all of the IDBs issued in these three states in 1991 had an issuance amount under $10 million.

Issuers Generally Do Not Have Requirements to Achieve Additional Public Benefits

While IDBs were used to finance projects that meet the basic eligibility requirements specified in the IRC, the projects have not generally been required to achieve the additional public benefits claimed by IDB proponents. The IRC does not require that these benefits be achieved, nor does it require that state or local issuers develop requirements for achieving additional benefits.

Nearly three-quarters of the states—37 in 1991—did not have additional requirements for issuing IDBs. Instead, these states, which issued

[1] Information was unavailable on how 5 percent of the funds were apportioned.

70 percent of the bonds in 1991, authorized IDBs that qualified under the federal criteria on a first-come, first-served basis. Only 13 states, accounting for approximately 30 percent of the total amount of IDBs issued during that year, had additional criteria focusing IDBs on specific public benefits, such as job creation and retention or assisting economically depressed areas. (See app. I for details on state issuance criteria.)

In more than half the states—30 in 1991—localities issued part of the state's IDBs, but the only information available—the results of our questionnaire to state officials—indicates that many, if not most, of these localities did not have additional issuance criteria beyond the basic IRC requirements and state criteria, if any. According to state officials, in 1991 local issuers in nine states had no additional criteria for approving projects for IDB financing. In 13 states the officials did not know whether local issuers had any additional criteria. In the remaining eight states, the officials stated that their local issuers did have additional issuance criteria for approving IDB financing. However, even in these eight states, not all local issuers may have had additional criteria. For example, while Ohio was among those 8 states where local issuers were reported to have had additional criteria, we found that 3 of the 12 localities had no criteria beyond the basic IRC requirements. In Indiana, we found that 7 of the 13 local issuers had no additional criteria. (New Jersey did not have local IDB issuers in 1991.)

Because federal legislation does not require IDBs to achieve benefits beyond financing small manufacturing projects, and the majority of state issuers and many local issuers do not have additional criteria for approving IDBs, the public sector is generally not attempting to direct this tax-exempt financing toward projects likely to achieve the public benefits purported by proponents of the IDB provision. Furthermore, since a large portion of IDBs are issued on a first-come, first-served basis to any project that meets the basic IRC requirements, IDBs may be used for projects that would have been done without the assistance of tax-exempt financing.

Attainment of Claimed Public Benefits Is Limited in Three States Reviewed

Although issuers generally have not directed IDBs toward achieving specific public benefits, proponents of the bonds, such as state economic development authorities, credit IDBs with attaining extensive benefits, such as creating jobs, assisting start-up companies, fostering economic development in distressed areas, and keeping manufacturing companies from moving their operations to foreign countries. Our review of IDB use in three states indicates that the job creation attributed to these projects would likely have occurred without IDBs, and that the projects achieved other benefits to a limited extent.

Job creation is one of the major benefits that proponents of IDBs claim result from the financing. Accordingly, we interviewed developers of the projects receiving IDBs in Ohio, Indiana, and New Jersey in 1991 to obtain their views on the job impact of IDBs. According to the developers' responses to the question of what would have happened if IDBs had been unavailable, of the 68 projects, 41 (or 60 percent) would have been done in any event, and the remaining 27 projects (or 40 percent) would not have been done. Of the 41 projects that would have been done without IDBs, 14 would have been done essentially the same. Twenty-two projects would have been scaled down and 12 of these 22 would also have experienced delays—usually of 24 months or less, according to the developers. Five other projects would not have been scaled down but would have experienced delays. In total, the estimated effect of project scale-downs and cancellations is that of the 3,500 jobs that developers said their projects would create, about 1,700 jobs would have been created in any event, while about 1,800 jobs would not have been created without IDBs.

The 1,800 jobs may not represent net new job creation, however, because this estimate does not take into account that if money were not invested in IDB projects, the money would be used elsewhere in the economy, also creating jobs. Whether IDB financing would create more or fewer jobs than alternative investments is unknown, but the result would depend on the specific alternative investment.

A recent report to the Congress provides an example of the economic questions raised about the impact of IDBs.[2] The report states that tax-exempt bonds, including IDBs, do not generate investment and employment increases for the nation and that net federal tax revenues do not rise in response to their issuance. In addition, the report claims that any investment and employment gains made by a specific state or locality as a result of IDB issuance are offset by lower levels of investment and employment elsewhere. The report states that

> it may be true, as some contend, that these bonds (small issue IDBs) generate Federal tax revenues and employment. But it is also true that Federal revenues and employment decline in those areas from which investment is displaced by the bonds. The net change is likely to be close to zero.

[2] Expiring Tax-Exempt Bond Provisions: Small Issue IDBs and Mortgage Revenue Bonds, Congressional Research Service Report for Congress, June 15, 1989.

Because it is unlikely that IDBs create more jobs than would be created through alternative investment of the money elsewhere in the economy, job creation may not be a meaningful or measurable public benefit requirement for IDBs.

In addition to job creation, the significant achievement of other public benefits frequently credited to IDB financing was not supported by our review of IDB use in the three states. Benefits of assisting start-up companies, providing economic growth to economically depressed areas, and preventing IDB-financed projects from leaving the country did not occur in the majority of cases we reviewed.

Most companies that obtained IDB financing were generally well established, financially sound companies that had been in operation for many years. Information available on 66 of the 69 companies that obtained IDBs in 1991 in Ohio, Indiana, and New Jersey,[3] shows that only 7 were start-up companies. The companies receiving IDBs had been in business an average of 33 years[4] and had annual sales averaging $27 million.[5] At 65 of the 66 companies using IDBs in 1991, the number of existing employees ranged from 1 or 2—for the seven start-up companies—to 500, for an average of 98 employees; one other company reported having 9,000 employees.

Furthermore, for the 68 projects financed with IDBs in 1991 in the three states reviewed, only 16 projects were located in areas of high unemployment.[6] Out of the 68 projects, only one developer claimed that his project would have relocated to another country without IDB financing.

IDBs represent a very small percentage of total nationwide manufacturing investment and are limited in use in several states. For example, IDBs issued in 1991 totaled approximately $1 billion nationwide,[7] according to our review—about one-half of 1 percent of the approximately $184 billion invested in new manufacturing plant and equipment in that year.[8]

[3]These 66 developers were responsible for 68 IDB-financed projects in Ohio, Indiana, and New Jersey.

[4]Average based on responses available for 62 companies.

[5]Average based on responses available for 48 companies.

[6]Cities of at least 25,000 and all counties defined by the Department of Labor as Eligible Labor Surplus Areas.

[7]IDB expenditures include manufacturing plant and facilities, machinery and equipment, and other costs.

[8]Department of Commerce, Bureau of the Census. (Data exclude agriculture.)

Moreover, 12 states issued no IDBs, and 10 others each issued less than $10 million in IDBs in 1991. Officials from five states[9] with relatively low IDB dollar volume generally stated that one of the reasons for the low IDB use was developers' difficulty in securing credit agreements to protect investors. Specifically, difficulty in arranging credit was attributed to economic recession and a reluctance by banks to accept real estate as collateral. Other reasons cited for low IDB use included uncertainty about the extension of the provision authorizing small issue IDBs and high issuing costs for developers.

Developers Benefit From IDBs Through Lower Capital Costs

While it is unclear whether IDB financing is achieving the public benefits claimed by its proponents, it is clear that private companies benefit substantially from IDBs. Developers benefit from IDB financing through lower interest rates and, therefore, a lower cost of capital. Virtually all developers viewed the lower cost of capital as the major benefit of IDBs. However, as stated above, a large portion of the developers said that the absence of IDBs would not have precluded them from proceeding with their projects.

For the 66 developers contacted in Ohio, Indiana, and New Jersey, 94 percent of the respondents stated that IDBs enabled them to obtain a lower cost of capital; of these, about 60 percent stated that the lower cost of capital was the most important benefit IDBs provided them. Other benefits cited included the ability to expand operations (9 percent), availability of the amount of capital needed (9 percent), opportunity to obtain long-term financing (6 percent), and the availability of financing coupled with a low interest rate (8 percent).

Although the developers generally viewed the lower cost of capital as an important benefit of IDBs, for a large portion of the projects, the availability of the financing was not a determinative factor in whether or not the project proceeded. As stated above, according to the developers, 41 of 68 projects, or 60 percent, would have gone forward without IDBs, either as essentially the same project or as a scaled-down project. For these 41 projects, 85 percent of the developers stated that at least three-fourths of the substitute financing for these projects would have been obtained from private or internal sources.

The following examples provide details of two projects that were financed with IDBs in 1991:

[9] California, Texas, Louisiana, Florida, and Connecticut.

- A manufacturer of petroleum lubricants, whose parent company is domiciled in another country, started operations the year before applying for the IDB, and at the time of application had 30 employees. The company obtained an $8 million IDB, and 96 percent of the funds was used to construct a manufacturing facility. Approximately 40 percent of the project's total costs was financed by the IDB; the remaining funds were obtained from private and internal sources. The developer estimated that the project would create 25 new jobs. According to the developer, if IDB financing had not been available, the company would have gone forward with the project without any changes, using private or internal funding sources. The developer also stated that the most important benefit the IDB provided was the interest rate, which led to a lower cost of capital.
- A sheet metal products manufacturer that had been in business for 51 years, with 1991 annual sales of $16 million, obtained a $750,000 IDB to finance 71 percent of a project involving construction of a manufacturing facility. The remaining costs were financed through a local loan program and private funds. At the time the IDB was obtained, the company had 60 employees. However, the developer stated that, because of an economic downturn, no new jobs had resulted from the project. According to the developer, the most important benefit of IDB financing was the ability to remain in business, and without IDBS, the project would not have been done.

Conclusions

While IDBS have been used for their intended purpose of financing manufacturing facilities, it is unclear whether IDBS significantly achieve for the nation the other public benefits that have been attributed to them. These claimed public benefits, such as job creation, assisting start-up companies, aiding economically distressed areas, and keeping companies from moving operations to foreign countries, are not required by the IRC, and state and local issuing authorities generally have not attempted to direct IDBS toward projects that might achieve such benefits. The IDB-financed projects we reviewed in three states achieved some of the benefits claimed by IDB proponents to a limited extent. However, the job creation benefits claimed for the projects would likely have occurred without IDB tax-exempt financing. Much of the job creation associated with these projects would have occurred anyhow because the same project or a scaled-down project would have been done in the absence of IDBS. Furthermore, for the projects that would have been scaled down or cancelled without IDBS, the money not spent on the projects would have been used elsewhere in the economy, also creating jobs. Because IDB use is not focused on public benefits and our work in three high-volume states shows limited achievement of public benefits, we question whether the benefits IDBs achieve for the nation are worth the tax revenue forgone.

The public benefits achieved from IDBs might be increased through more specific requirements for their use, provided that the requirements direct IDBs toward achieving benefits that would not occur through investing the money elsewhere in the economy. Because it is unlikely that IDBs create more jobs than would be created through alternative investment of the money, job creation may not be a meaningful or measurable public benefit requirement for IDBs. However, assisting economically distressed areas or fostering start-up companies would not necessarily occur from alternative investment of the money and may, therefore, be more effective public benefit requirements for IDBs.

Matter for Congressional Consideration

Given the questions that surround whether IDBs are achieving the benefits attributed to them and in view of the tax revenue forgone, the Congress may wish to consider not renewing the IDB provision. If, however, the Congress should act to extend the provision, it may wish to specify requirements to better direct IDBs toward achieving public benefits that would not occur from alternative investment of the money. For example, the Congress may wish to provide requirements that would direct IDBs to economically distressed areas or to start-up companies.

Agency Comments

As requested, we did not obtain written agency comments on a draft of this report. However, we discussed the information presented in this report with the Director, Office of Tax Analysis, and other officials of the Department of Treasury, who generally concurred with the facts presented in this chapter as well as the facts presented in the other chapters of the report. We have incorporated changes suggested by the agency where appropriate. We also discussed the information contained in the report with the Deputy Director, Indiana Development Finance Authority; the Executive Director, New Jersey Economic Development Authority; and the Manager, Office of Financial Incentives, Ohio Department of Development. These officials generally agreed with the facts presented about their states but strongly believe that IDBs create jobs in their states. The state officials expressed surprise that 60 percent of the developers receiving IDBs in 1991 in the three states said they would have gone forward with essentially the same project or a scaled-down project without IDBs. We believe, however, that because the developers—beneficiaries of IDBs—provided this response, much of the job creation occurring from the projects in these three states cannot be attributed to IDBS. Furthermore, for those projects that would not have gone forward without IDBS or that would have been scaled down without IDBS, the money would have been used elsewhere in the economy, which would also have created jobs, not necessarily in the three states, but in the nation as a whole.

IDBs Seldom Default, and IDB Projects Remain in Manufacturing Use

Because of the magnitude of the tax revenue forgone to finance IDB projects, the default of the bonds or their early payoff and subsequent use of the projects for purposes other than manufacturing would raise additional concerns about what public benefits IDBs achieve. However, few IDBs have defaulted, which may be linked to precautions involved in the issuance and repayment process that are intended to ensure that project developers are creditworthy and that IDB projects are sound business ventures. In addition, for projects financed between 1987 and 1991 in the three states we reviewed, few IDBs were paid off early; of those that were, none of the projects were subsequently used for purposes other than manufacturing. When IDBs were paid off early, it was generally to refinance the debt at a more favorable interest rate or because the developer had accumulated sufficient financial resources to retire the debt.

Few IDBs Have Defaulted

A high rate of default for IDBs would raise the concern that the federal government has forgone tax revenue for IDB issuance only to have the projects fail and thereby lose much of the public benefits the projects might produce. However, in the three states we reviewed—Ohio, Indiana, and New Jersey—few IDBs have defaulted, according to state officials responsible for IDB issuances. Less than 1 percent, or 4 of the 523 IDBs issued in these states during 1987 through 1991, have defaulted. Ohio had one IDB that defaulted, Indiana had none, and New Jersey had three. The officials had little specific information on the reasons for the few defaults that did occur. For the single default in Ohio, officials provided general information which suggested that the default was due to circumstances other than the financial viability of the manufacturing project. Officials from New Jersey and Indiana explained that, while they believe they would be aware of any IDB defaults that might occur in their states, they do not maintain information on the circumstances surrounding IDB defaults.

Issuance Process Entails Safeguards to Ensure Developer Creditworthiness and Deter IDB Defaults

The low default rate for IDB projects may be attributable to safeguards that exist in the issuance process to ensure the project developer was creditworthy. Even though the bonds are repaid by the developer and not the state or local issuer, IDBs are associated to some extent with the credit standing of the issuer. Thus, issuers, because they are concerned about their own credit standing, generally require that developers demonstrate strong creditworthiness. Other participants in the issuance process also provide assurances that the bonds will not fail.

Specifically, because the bonds are in the issuer's name, the issuer's credit reputation is linked with the IDB projects it approves. If a default occurs, the issuers believe their credit standing could come under scrutiny and be downgraded. Downgrading credit usually results in more costly financing because investors demand a higher return for greater risk. For this reason, issuers generally take precautions to ensure that IDBs do not default.

To safeguard their credit standing, as well as the funds of IDB investors, issuers in Ohio, Indiana, and New Jersey generally require developers to obtain a letter of credit as a prerequisite for IDB financing. A letter of credit is an agreement issued by a bank, for a fee, guaranteeing that a developer will meet the interest and principal obligations of the IDB up to a stated amount for a specified time period. In case of default, the letter of credit substitutes the bank's credit for the developer's payments and reduces the financial risk for investors and issuers.

Besides state and local issuers, other participants involved in reviewing IDB applications and issuing the bonds—bond counsels, underwriters, and banks—provide additional assurances that IDBs will not default. Bond counsels guide IDB applications through the various levels of review and certify conformance with applicable federal, state, and local laws pertaining to the bonds; that is, they certify that all legal requirements are met. Underwriters—for example, investment bankers—market the IDBs by purchasing the bonds and subsequently selling them to investors, such as mutual funds, banks, or company pension funds. In most cases, a trustee from either the letter of credit bank or another financial institution disburses payments to investors on behalf of the developer and controls the disbursement of bond proceeds to the developer. Because these participants in the IDB issuance and repayment process all have an interest in the success of the IDB project—either professional or financial—their involvement provides additional assurance that the project is financially sound.

Another possible reason for the low rate of IDB defaults is that the projects are receiving subsidized financing, making repayment of the debt less burdensome. Since 94 percent of the developers we contacted stated that the bonds lowered their cost of capital, this could be a factor contributing to the low rate of defaults we found in the three states reviewed.

Although the safeguards involved in the issuance and repayment process and the advantage of subsidized financing provide some assurance of project viability, these factors do not remove the possibility of bond default. For example, we found in a 1991 report that bonds issued in the 1980s to finance retirement centers had a default rate of about 20 percent, despite the existence of some similar issuance safeguards.[1] We also found that the average amount of time from issuance of the retirement center bonds to default was about 34 months. Therefore, while very few IDBs have defaulted in the three states we reviewed, as more time elapses the number of IDB defaults may increase.

Prepayment of IDBs Is Infrequent

Early payment (known as prepayment) of an IDB removes any legal restrictions on the subsequent use of the project. However, the subsequent use of the project for a nonmanufacturing purpose would raise questions about what public benefit was obtained from the tax-exempt financing. In the three states we reviewed, IDBs were infrequently prepaid, and when they were, all indications are that the projects continued to be used for manufacturing.

For all IDBs that Ohio, Indiana, and New Jersey issued in 1987 through 1991, as of December 1992 about 4 percent, or 20 of 523 bonds, had been paid off before their maturity dates, according to responsible state officials. (IDB maturity periods vary from bond to bond but usually range between 10 and 30 years.)

While state officials knew the number of IDBs prepaid in their state, they did not maintain records on why the prepayments occurred. However, they provided their general knowledge on the reasons behind the prepayments. For example, an Ohio official said that prepayments in that state probably resulted when the company that initially obtained the IDB financing was purchased by another manufacturing concern or the developer had sufficient financial resources to retire the bond. A New Jersey official stated that, to his knowledge, IDBs were prepaid to refinance projects at a more favorable interest rate.

None of the state issuers we interviewed could recall any cases in which IDBs were paid off early and the projects were subsequently used for nonmanufacturing purposes. This occurrence is unlikely because the kinds of facilities financed with IDBs are specialized for manufacturing; therefore, converting the facilities to other purposes would not be cost-effective.

[1] Tax-Exempt Bonds: Retirement Center Bonds Were Risky and Benefited Moderate-Income Elderly (GAO/GGD-91-50, Mar. 29, 1991).

Of the total IDB funds issued in 1991 in the three states reviewed, about half were used to purchase manufacturing machinery and equipment. The remaining funds were used to construct or purchase and rehabilitate manufacturing facilities, or for other related expenses.

Conclusions

Concerns that the public benefits generated by IDBS might be affected by a high rate of defaults or prepayments are not borne out by our work. In the three states we reviewed, IDBS are seldom subject to default or prepayment. The IDB issuance process involves several safeguards to ensure that the developers using IDBS are creditworthy and that the projects financed with IDBS are sound business ventures. Moreover, because of the tax-exempt subsidy IDBS offer, a low default rate on these bonds is consistent with what might be expected. In the limited instances in which IDBS were paid off early, no evidence exists that the projects have been used for anything other than manufacturing. Furthermore, the high cost of converting manufacturing facilities to other purposes makes such a conversion unlikely.

States' Criteria for Approving Manufacturing Projects for IDB Financing

State	Criteria
California	California requires job creation at a ratio of one job created for every $50,000 spent; it also takes into consideration the project's public benefits, such as hiring displaced workers, locating in an enterprise zone, and maintaining pollution control.
Colorado	Colorado ranks projects on the basis of all the following criteria taken as a whole: job creation/retention, existing or projected community needs, priorities of local government, feasibility of the project, availability of alternative financing, local government's capacity to accommodate the project's impact, previous performance of the developer with private activity bonds, and competition with other bond issues.
Georgia	Georgia requires job creation at a ratio of one job created for every $125,000 spent.
Maine	Maine requires that the project have no detrimental impact on industry competitors located within the state and that all necessary licenses be granted by the Environmental Protection Agency. The project must also provide public benefits, such as job creation or an augmented tax base.
Massachusetts	Massachusetts requires a project to provide job creation/retention at a ratio of either one job per 1,300 square feet of building space developed or one job for every $65,000 spent on purchases of equipment. In addition, the state requires that the developer retain ownership of all land and project facilities for at least 3 years, that annual sales of the company not exceed $30 million, and that if the company is relocating, accommodations be made for existing employees. If any of these criteria are not met, the project must serve a public purpose, such as being located in a community where unemployment is high, or the project must have above-average growth potential. Also, the project can be involved in emerging technologies, a minority-owned business, or a child care facility.
Minnesota	Minnesota uses a work sheet to score public purpose, assigning point values to the project on the basis of its proposed public benefits, such as job creation/retention, augmentation of the tax base, and location in areas of high unemployment.
Missouri	Missouri requires a project to create jobs.
New York	New York considers the impact that the project will have on areas that are already economically developed, the contribution it will make toward revitalizing distressed regions, the assistance that will be provided to targeted groups and industries, the amount of job creation/retention, the amount of state dollars needed to invest to create jobs, and the issue of whether the project is in a growth industry that will contribute to the state's long-term economic development.

(continued)

State	Criteria
North Carolina	North Carolina requires that a developer pay above-average manufacturing wages, not relocate the new facility in a different county, and be able to repay the bond. The state also requires that the project not harm the environment and the state considers job creation/retention, impact of the bond on the community, and competition with other bond issues.
Oregon	Oregon requires that the project have a national or international market. Oregon also considers the state's estimated loss of tax revenue compared with the estimated payroll and profit taxes available after the project is completed.
Pennsylvania	Pennsylvania requires job creation/retention at a ratio of one job created for every $50,000 spent.
Vermont	Vermont ranks projects on the basis of all the following criteria taken as a whole: overall feasibility of the project, protections afforded to bondholders, and job creation.
Washington	Washington considers whether a project is located in a county affected by problems in the timber industry or high unemployment and requires job creation at a ratio of one job for every $200,000 spent.

Note: All other states use no criteria other than federal requirements. Bonds are issued on a first-come, first-served basis.

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