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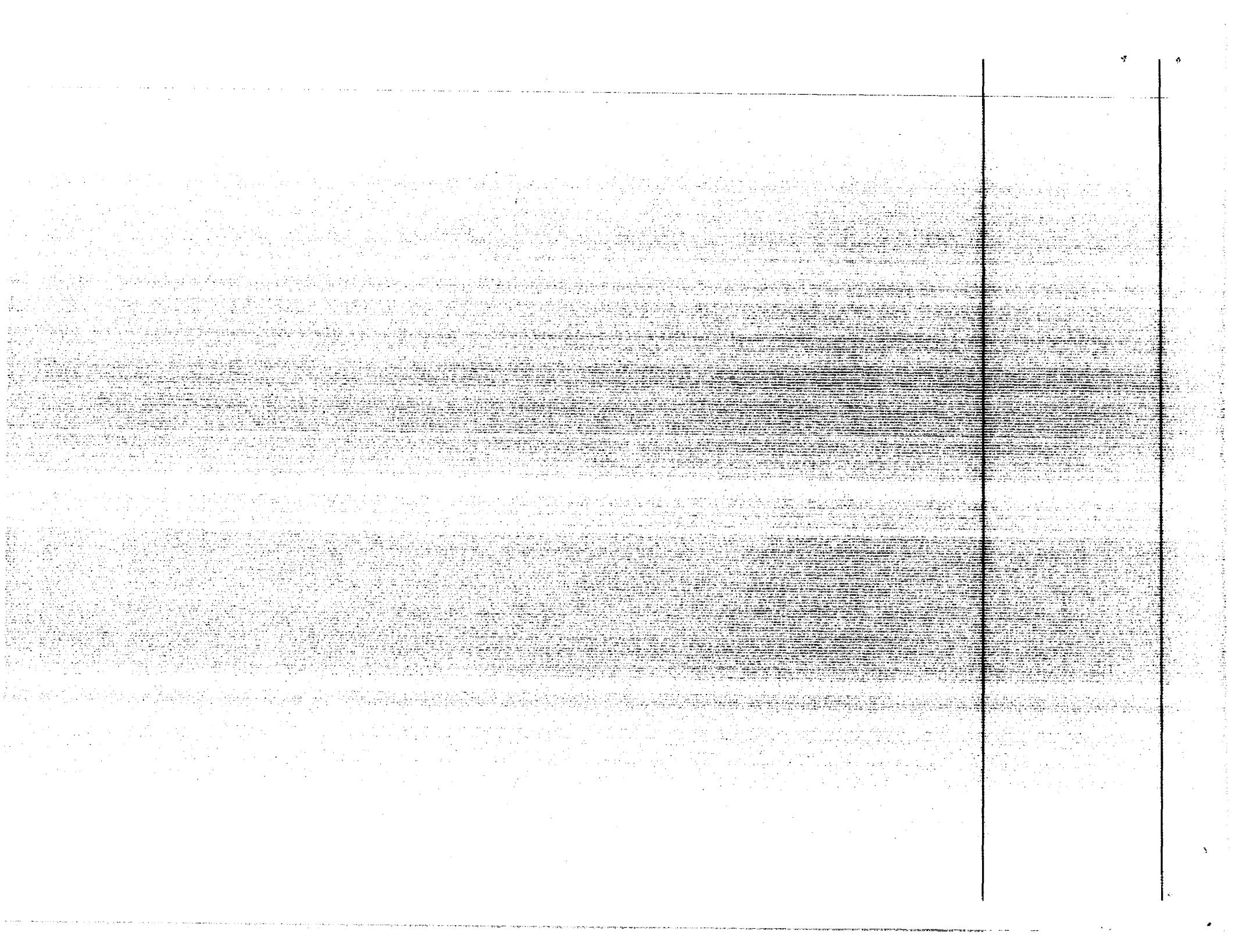
United States General Accounting Office
Briefing Report to the Honorable
Brian Donnelly, House of
Representatives

December 1989

TAX POLICY

Tax-Exempt Bond Issuance Costs







United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-234206

December 18, 1989

The Honorable Brian Donnelly
House of Representatives

Dear Mr. Donnelly:

This briefing report responds to your September 23, 1988 request that we study the costs incurred by state and local governments in issuing tax-exempt bonds. Issuing tax-exempt bonds can be a complex process, and issuers generally require specialized services to assist in planning and selling the bonds. Because of your concern that the cost of these services (issuance costs) may be artificially high, placing an unnecessary burden on governments and diverting bond proceeds from legitimate governmental purposes, you introduced legislation in 1988 (H.R. 5350) to limit issuance costs of tax-exempt bonds.

BACKGROUND

State and local governments use tax-exempt bonds to finance public purpose projects, such as schools and roads. Tax-exempt bonds can be classified by the security pledged for payment of the debt (general obligation or revenue) or the type of entity using the bond proceeds (private activity or governmental). The total volume of tax-exempt bonds has grown rapidly during the last decade. The growth in private activity bonds (e.g., bonds whose proceeds are used by private businesses, organizations, or individuals) raised congressional concern that tax-exempt financing should be better targeted to serve a public rather than a private purpose.

The Tax Reform Act of 1986 contained several provisions that addressed tax-exempt financing. One provision was aimed at preventing the excessive diversion of bond proceeds to

specialists involved in the planning and selling of the bonds. In general, the act restricted the amount of private activity bond proceeds that could be used to pay issuance costs to 2 percent.

The limits proposed in 1988 (H.R. 5350) would further reduce the amount of bond proceeds that could be used to pay issuance costs. The 2-percent limit on issuance costs paid from bond proceeds for private activity bonds would be reduced to 1 percent. The proposal also stipulated that any bond for which issuance costs, whether paid from bond proceeds or from other funds, exceeded specified amounts would not qualify as tax-exempt. The limits on issuance costs would range from 3.5 percent of bond proceeds for issues \$5 million or less to 1 percent for issues greater than \$75 million.

RESULTS IN BRIEF

Our analysis showed that issuance costs as a percentage of bond proceeds vary by bond purpose and size. For tax-exempt private activity bonds issued in 1985, the costs ranged from 2.2 percent for bond issues greater than \$75 million to 4.1 percent for bond issues between \$10 and \$25 million. The largest component of issuance costs was the underwriter spread. The spread is the difference between the price the underwriter pays the issuer for the bonds and the price at which the underwriter sells the bonds to investors. Available data on bonds issued in 1988 show underwriter spreads varied from 48 to 88 percent of issuance costs depending upon the size of the bond issue. Underwriting spreads have fallen about 40 percent from 1982 to 1988.

We evaluated whether additional limits should be imposed on issuance costs by applying economic principles to assess the competitiveness of tax-exempt bond underwriting. If underwriting is relatively competitive, then underwriter spreads should reflect the costs of underwriting services and a reasonable profit. By analyzing the market shares of the underwriting firms and the potential barriers to competition, we concluded that underwriting is relatively competitive. Thus, additional limits do not seem justified on economic grounds at this time.

Internal Revenue Service (IRS) and Financial Markets Research Center, State University of New York (FMRC), data show that significant percentages of tax-exempt bonds had issuance

costs that would exceed H.R. 5350 limits. IRS data, for example, indicate that a high percentage of private activity bonds issued in 1985 and 1986 (44 and 37 percent respectively) would exceed the proposed limits. Since underwriting is relatively competitive, it is unlikely that underwriters would reduce fees and still provide the same level of service. Therefore, unless issuers and providers of issuance services found ways to redistribute or reclassify issuance costs, the proposed limits could restrict state and local governments' ability to issue tax-exempt bonds.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of this report was to address three questions:

- What are the average issuance costs associated with issuing tax-exempt bonds, and are these costs burdensome on state and local governments?
- Should the existing limitations on issuance costs for private purpose bonds be further reduced, and should new limitations be imposed on all other tax-exempt bonds?
- Will the proposed limitations restrict the ability of state and local governments to issue bonds?

To answer these three questions, we interviewed various public and private sector representatives having knowledge of the tax-exempt bond area to (1) identify data bases on issuance costs, (2) discuss the process used to issue tax-exempt bonds, and (3) obtain views on the potential effects of your proposal. Among others, our discussions involved officials from IRS, Treasury, the Government Finance Officers Association (GFOA), Securities and Exchange Commission, Public Securities Association (PSA), and the National Association of Bond Lawyers.

We identified three sources of data on issuance costs. First, we obtained IRS Form 8038 data on private activity bonds issued in 1985 and 1986, which is the most current data available. This form requires issuers to list, among other things, the amount of issuance costs paid from bond proceeds. Second, the Public Securities Association provided us data on underwriter spreads for 1982 through 1988 and information on individual firms' market shares in 1988. Third, we obtained the preliminary results of a survey of issuance costs for all types of tax-exempt bonds done by the Financial Markets

Research Center. This survey was sponsored by the Government Finance Officers Association. We combined these three sources to gain a better perspective on issuance costs. To gain further perspective, we researched the relevant financial and economic literature.

Lastly, we evaluated the competitiveness of the underwriting of tax-exempt bonds to determine whether additional limits should be placed on issuance costs. Economic theory maintains that the fees charged by firms will not be excessive if large numbers of firms are competing and if competitors can readily enter a market if they believe profits are high. We used standard economic methods, such as those detailed in the Department of Justice's Merger Guidelines, to analyze the degree of market concentration and whether barriers to competition exist.

It was beyond the scope of this report to evaluate whether all issuers incur the lowest possible cost for the services they purchase. By evaluating the competitiveness of the underwriting industry, we sought to determine if issuers have the opportunity to obtain the services for fees that reflect the cost of the service and a reasonable profit. The ability of issuers to use this opportunity to find the lowest available price is largely dependent on such factors as their expertise and the extent to which they pursue information concerning the prices and quality of services.

We did our work from December 1988 to August 1989 and in accordance with generally accepted government auditing standards. We discussed the draft report with representatives of the Public Securities Association, Government Finance Officers Association, and Internal Revenue Service. The officials agreed with the information presented, and we have included their comments where appropriate.

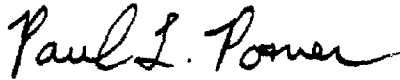
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As arranged with your office, we are sending copies of this report to interested parties and will make copies available to others upon request.

B-234206

The major contributors to this report are listed in appendix II. If you have any questions about the report, please call me at 272-7904.

Sincerely yours,

A handwritten signature in cursive script that reads "Paul L. Posner".

Paul L. Posner
Associate Director, Tax Policy and
Administration Issues

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ABBREVIATIONS

FMRC	Financial Markets Research Center
GFOA	Government Finance Officers Association
IRC	Internal Revenue Code
IRS	Internal Revenue Service
PSA	Public Securities Association

GAO What Are Tax-Exempt Bonds?

- Debt instruments used by state and local governments to finance public-purpose projects
 - Classified by the security pledged for payment of the debt (general obligation or revenue) or the type of entity using the bond proceeds (private activity or governmental)
-

WHAT ARE TAX-EXEMPT BONDS?

The Internal Revenue Code (IRC) allows state and local governments to issue bonds that provide investors with interest income that is exempt from federal income tax. This exemption allows governments to issue debt at lower interest rates than they otherwise would have to pay. Tax-exempt bonds are used by state and local governments to finance public-purpose projects, such as schools, roads, or water and sewer facilities. State and local governments can also provide tax-exempt financing for tax-exempt organizations and private persons or organizations if the proceeds are used for certain activities specified in the IRC.

Tax-exempt bonds can be classified by the source of revenue that backs the issue or by the type of entity that uses the proceeds. General obligation bonds are guaranteed by the full faith, credit, and taxing power of the issuing government. Revenue bonds are backed by a source of revenue, such as proceeds from a particular tax or from the project being financed. The tax code characterizes tax-exempt bonds according to the entity using the proceeds. In general, private activity bonds are bonds where more than 10 percent of the proceeds are used by a nongovernmental private entity and more than 10 percent of the principal or interest is directly or indirectly paid from, or secured by, revenues from a private trade or business. The IRC restricts the size and types of activities that can be financed with tax-exempt private activity bonds. In general, governmental bonds are those bonds where 90 percent or more of the proceeds are used for governmental purposes.

The volume of tax-exempt bonds has grown rapidly in recent years, with total volume outstanding growing from \$290 billion in 1978 to \$760 billion in 1988. The share of total outstanding tax-exempt financing used for private activities increased from 12 percent in 1978 to 32 percent in 1985 and declined to 26 percent in 1988. The Joint Committee on Taxation estimates that the sum of tax expenditures on all types of tax-exempt bonds for fiscal year 1990 will be \$20.3 billion.

GAO Process for Issuing
Tax-Exempt Bonds

Specialized services are generally needed to assist issuers in planning bond issues and selling bonds. These services may include

- underwriting,
 - legal,
 - financial,
 - bond rating, and
 - printing.
-

PROCESS FOR ISSUING TAX-EXEMPT BONDS

Issuing tax-exempt bonds can be a complex process. Specialized services are generally needed to assist issuers in planning the bond issue and selling the bonds. Costs associated with these services (issuance costs) include fees paid to underwriters, financial advisors, bond counsels, rating agencies, paying agents, accountants, printers, and advertisers. The extent to which issuers hire private firms for these services generally depends upon the issuers' in-house expertise in issuing tax-exempt bonds and the type and purpose of issue.

Planning a bond issue requires legal and financial services. Generally, bond counsels prepare pertinent legal documents and assure that the proposed sale is consistent with local, state, and federal laws and regulations. Financial advisors assist issuers in determining such things as the size of issue, the bonds' maturity, and the security pledged for payment of the debt. Financial advisors may also assist issuers in determining the best method to sell the bonds to the underwriting firm(s), who in turn resell the bonds to investors. In a competitive sale, the issuer formally invites underwriters to bid on the bond offering. In a negotiated sale, the issuer selects an underwriter, perhaps after hearing proposals from several underwriters. In both cases, underwriters may join together and form a syndicate to buy the bonds. Issuers compensate underwriters for assuming risk and for incurring the costs of selling the bonds through the underwriter spread. The spread is the difference between the price the underwriter pays the issuer for the bond and the price at which the underwriter sells the bonds to investors.

Issuers may use other specialists, such as rating agencies, bond insurers, accountants, consultants for feasibility studies, and printing and advertising firms. Rating agencies evaluate the credit-worthiness of the bonds being offered. Bond ratings provide information on the credit-worthiness of the offering to potential investors. Bond insurance protects the investor against default. Investors are willing to accept lower interest payments for less risky bonds.

GAO Current Legal Treatment of
Issuance Costs

- Profits earned by investing tax-exempt bond proceeds in higher yielding assets cannot be used to finance issuance costs.
 - The amount of bond proceeds that can be used to pay issuance costs for private activity bonds is limited to 2 percent.
-

CURRENT LEGAL TREATMENT OF ISSUANCE COSTS

The Tax Reform Act of 1986 made several changes to better ensure that tax-exempt bond financing is used efficiently and funds are targeted to serve a recognized public purpose rather than a private purpose. Among the changes were two provisions regarding issuance costs.

First, the act tightened the arbitrage rules so that issuers cannot recover issuance costs through arbitrage profits (profits earned by investing tax-exempt bond proceeds in higher yielding financial assets). The ability to earn and retain arbitrage profits gives issuers an incentive to issue more bonds, to issue them earlier, and to leave them outstanding longer than they otherwise would. This allows issuers to earn profits that need not be used for the stated purpose of the bond issue and increases the federal tax expenditure for tax-exempt bonds. While the ability of issuers to earn arbitrage profits was limited before the act, they were allowed to earn profits to cover issuance costs. This meant that issuance costs were effectively paid at the federal government's expense. The act changed the manner in which allowable arbitrage profits are calculated so that issuance costs are borne by issuers or the beneficiaries of the bond proceeds.

Second, the act restricted the amount of private activity bond proceeds that could be used to finance issuance costs to 2 percent to prevent the excessive diversion of bond proceeds to underwriters, attorneys, and other intermediaries.¹ Issuers were permitted to use other funds to pay any additional issuance costs. No percentage limits were placed on the amount of issuance costs that could be paid from bond proceeds for governmental bonds.

¹The limit is 3.5 percent for mortgage revenue bonds when the aggregate authorized face amount does not exceed \$20 million.

GAO Further Limits on Issuance Costs Proposed

- All bonds with issuance costs exceeding specified amounts would no longer qualify as tax-exempt.
- Limits would range from 3.5 percent of bond proceeds for issues \$5 million or less to 1 percent for issues greater than \$75 million.

FURTHER LIMITS ON ISSUANCE COSTS PROPOSED

Legislation was introduced in 1988 (H.R. 5350) that would impose new limits on issuance costs for all types of tax-exempt bonds and tighten existing limits for private activity bonds. Under the proposal, a bond (governmental or private activity) would not qualify as tax-exempt if issuance costs exceed specified amounts--regardless of whether the costs were paid from bond proceeds or other sources, such as general revenues.² The limits on issuance costs would range from a high of 3.5 percent of the total proceeds of the issue for bonds with a face amount of \$5 million or less to a low of 1 percent for bonds with a face amount greater than \$75 million. The current 2-percent limit on issuance costs paid from bond proceeds for private activity bonds would be reduced to 1 percent of bond proceeds, thereby making the limit more stringent.

²As a practical matter, the amounts of some issuance costs can be estimated at the time the bonds are issued, but the amounts are not known exactly until after the bonds are issued. Regulations would have to be written to deal with this matter.

GAO **Characteristics of Tax-Exempt
Bond Issuance Costs**

- Average issuance costs as a percentage of bond proceeds have varied by bond type and size of issue.
 - Underwriter spread has been the largest component of issuance costs.
 - Underwriter spreads, which vary by issue size, have fallen 40 % since 1982.
-

CHARACTERISTICS OF TAX-EXEMPT BOND ISSUANCE COSTS

We used three sources of data to identify various characteristics of tax-exempt bond issuance costs. We obtained IRS information return data for private activity bonds issued in 1985 and 1986, and we analyzed those bonds where issuers reported paying some issuance costs with bond proceeds. Our analysis showed that average issuance costs as a percentage of bond proceeds varied by bond type and size of issue. The Financial Markets Research Center's survey of issuance costs for all types of tax-exempt bonds issued in 1988 provided information on issuance cost components. The preliminary survey results showed that the underwriter spread was the largest cost component. Finally, we obtained underwriter spread data from the Public Securities Association and found that underwriter spreads for all tax-exempt issues varied by type of sale and size of issue. Individually, the sources do not provide a complete picture of tax-exempt bond issuance costs. The sources are complementary, however, and when combined provide an overall perspective.

GAO Average Issuance Costs Varied by Issue Size

Table I.1:

Issuance Costs as a Percentage of Private Activity Bond Proceeds--by Size of Issue

Size of issue (\$ millions)	1985		1986 ^a	
	# Issues	Average issuance cost %	# Issues	Average issuance cost %
\$5 or less	9,068	3.4	1,476	3.4
5 - 10	1,471	4.0	152	3.7
10 - 25	1,173	4.1	64	3.6
25 - 50	557	3.2	43	2.4
50 - 75	181	2.7	15	2.4
more than 75	<u>297</u>	<u>2.2</u>	<u>18</u>	<u>1.4</u>
Total	<u>12,747</u>	<u>3.5</u>	<u>1,768</u>	<u>3.4</u>

^aThe Tax Reform Act of 1986 placed a 2-percent limit (effective August 15, 1986) on the amount of bond proceeds that could be used to pay issuance costs. The 1986 data include only bonds issued before August 15, 1986.

Source: GAO calculations based on IRS Form 8038 data.

AVERAGE ISSUANCE COSTS VARIED BY ISSUE SIZE

We analyzed IRS data on private activity bonds issued in calendar years 1985 and 1986, which is the most recently available data. Since 1983, issuers of private activity bonds have been required to file IRS Form 8038, an information return, after each bond issue. Among other things, the form asks for information on issuance costs paid from bond proceeds. The amount reported, however, does not necessarily include all issuance costs because other funds can be used to pay these costs. Starting in 1987, issuers of governmental bonds were required to file a similar information return; however, these data are not yet available from IRS.

Table I.1 shows that average issuance costs vary by the size of the bond. Issuance costs as a percentage of bond proceeds are greater for smaller bonds. In 1985, issuance costs ranged from 4.1 percent for bonds between \$10 and \$25 million to 2.2 percent for bonds greater than \$75 million. This variance in percentages is not surprising, since there are certain fixed costs for each issue regardless of size.

GAO Average Issuance Costs Varied by Bond Type

Table I.2:

Issuance Costs as a Percentage of Private Activity Bond Proceeds--by Bond Type

Bond type	1985		1986a	
	# Issues	Average issuance cost %	# Issues	Average issuance cost %
Student Loan	70	2.5	32	3.0
Qualified Mortgage	209	2.1	10	1.9
Private Exempt Entity	1,421	3.3	123	3.7
Industrial Development:				
Industrial Park	52	3.8	11	2.8
Small Issues	8,453	3.3	1,379	3.3
Residential Rental	1,935	4.8	105	4.6
Sports Facilities & Conventions	48	3.4	5	3.0
Airport	147	3.1	21	2.8
Sewer & Pollution	369	2.7	48	2.9
Water, Hydro, Mass Commuting, Energy	36	3.2	8	7.3
Other (bond type unknown)	7	2.9	26	1.0
Total	<u>12,747</u>	<u>3.5</u>	<u>1,768</u>	<u>3.4</u>

^aThe Tax Reform Act of 1986 placed a 2-percent limit (effective August 15, 1986) on the amount of bond proceeds that could be used to pay issuance costs. The 1986 data include only bonds issued before August 15, 1986.

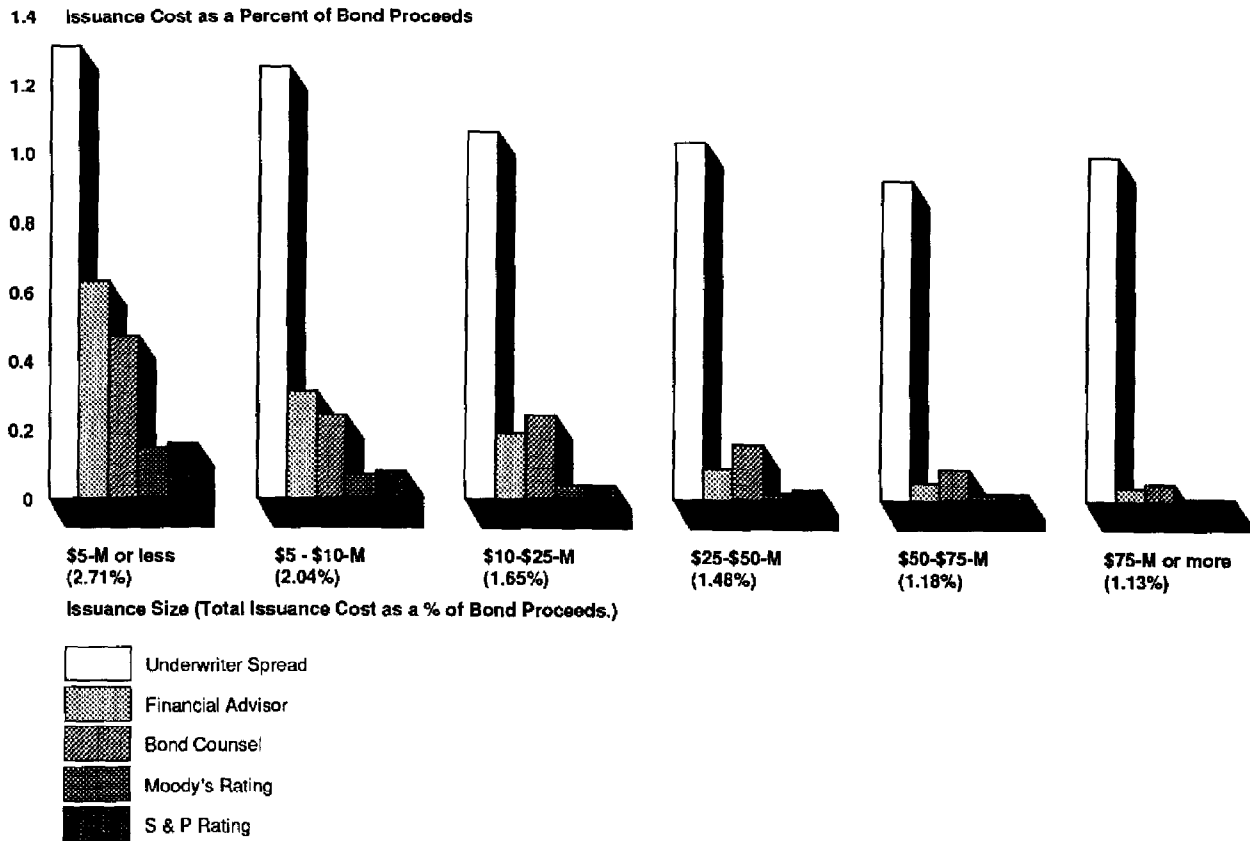
Source: GAO calculations based on IRS Form 8038 data.

AVERAGE ISSUANCE COSTS VARIED BY BOND TYPE

Table I.2 shows that average issuance costs for tax-exempt private activity bonds issued in 1985 and 1986 varied by type of bond. Average issuance costs were generally higher for private exempt entity bonds (issued for the use of nonprofit organizations) and certain industrial development bonds than for qualified mortgage and student loan bonds. For example, costs ranged from 2.1 percent for qualified mortgage bonds to 4.8 percent for residential rental industrial development bonds issued in 1985.

GAO Underwriter Spread Has Been the Largest Cost Component

Figure I.1: Major Components of Issuance Costs



Source: SUNY Albany, FMRC preliminary survey results, April 4, 1989.

UNDERWRITER SPREAD HAS BEEN THE LARGEST COST COMPONENT

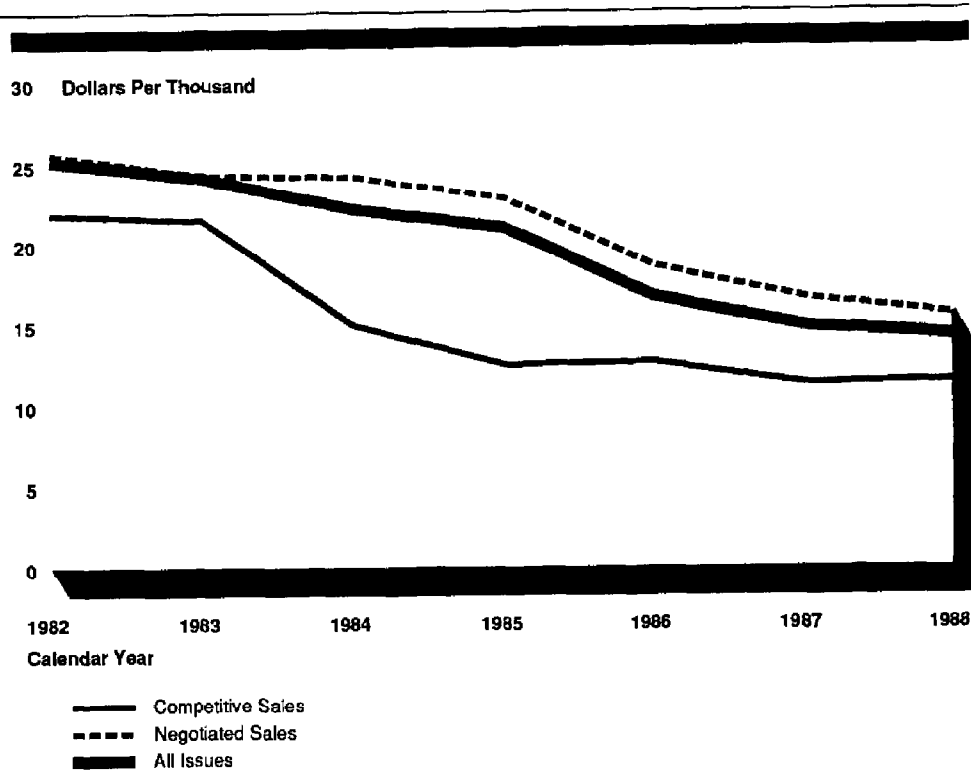
The Financial Markets Research Center, State University of New York, did a survey of issuance costs for revenue and general obligation tax-exempt bonds issued in 1988. As of April 1989, FMRC received 411 responses from the 1,605 governmental units surveyed, a response rate of 25 percent.

Figure I.1 illustrates the major cost components identified by FMRC's preliminary analysis of issuance costs. FMRC results show that underwriter spread was the largest component of total issuance costs. FMRC found that of the 290 responses reporting information on underwriter spreads, average underwriter spreads as a percent of issue size ranged from 1.31 percent (\$35,000 average cost) for issues of \$5 million or less to .99 percent (\$1.96 million average cost) for issues of \$75 million or more. Underwriter spread as a percent of total issuance cost ranged from 48 to 88 percent, depending upon the issue size. Financial advisor and bond counsel fees had the next highest average cost.

Although FMRC's results are preliminary and not projectable to all tax-exempt bonds, figure I.1 also shows that FMRC's results are consistent with IRS data showing that the average total issuance costs as a percentage of issue size have varied. The average total issuance cost ranged from 2.71 percent for bonds of \$5 million or less to 1.13 percent for bonds greater than \$75 million.

GAO Underwriter Spreads Have Fallen Over Time

Figure I.2: Underwriter Spreads by Type of Sale



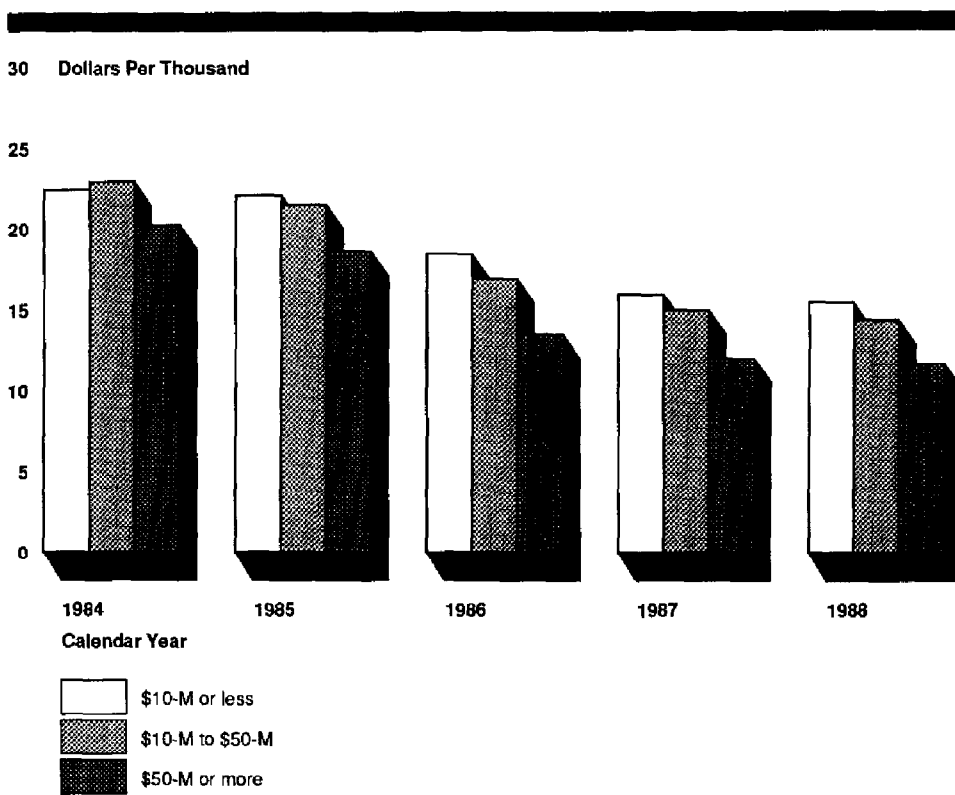
Source: PSA Municipal Database.

UNDERWRITER SPREADS HAVE FALLEN OVER TIME

Public Securities Association data on underwriter spreads for all tax-exempt issues show that spreads have fallen during the period 1982 to 1988. (See fig. I.2.) The data also show that underwriter spreads for negotiated issues are higher than for competitive issues. Since studies have shown that underwriter spreads are affected by a number of factors, including the level and variability of interest rates, underwriter spreads can be expected to vary over time as financial market conditions change.

GAO Underwriter Spreads Have Varied by Size of Issue

Figure I.3: Underwriter Spreads by Size of Issue



Source: GAO Calculations Based on PSA Municipal Database.

UNDERWRITER SPREADS HAVE VARIED BY SIZE OF ISSUE

Public Securities Association data (fig. I.3) show that average gross underwriter spread as a percentage of bond proceeds has been greater for smaller issues (less than \$10 million) than for large issues (\$50 million or more). The data also show that underwriter spreads fell for all size categories between 1984 and 1988.

GAO Should Additional Limits Be Placed on Issuance Costs?

- If bond issuance services are provided competitively, then from an economic perspective, limits would not be justified.
 - We assessed the competitiveness of the underwriting industry by analyzing
 - market definition,
 - market concentration, and
 - barriers to entry.
-

SHOULD ADDITIONAL LIMITS BE PLACED ON ISSUANCE COSTS?

If tax-exempt bond issuance services are not provided competitively, then the providers of these services could charge higher fees and capture some of the federal subsidy as monopoly profits. In this case, less federal subsidy would be available for the intended public purpose. If tax-exempt bond issuance services are provided competitively, then the fees paid would reflect the costs of the services (including a reasonable profit), and additional limits on costs would not be justified on economic grounds.

We analyzed the competitiveness of the underwriting industry since it is the largest component of cost. To do this, we used standard economic methods, such as those detailed in the Department of Justice' Merger Guidelines. Both Justice and the Federal Trade Commission use the guidelines to determine the impact of a proposed merger on the competitiveness of an industry. Accordingly, we assessed market definition, market concentration, and barriers to entry to evaluate the competitiveness of the underwriting industry.

GAO Market Definition

The underwriting industry is a national market.

- Many commercial and investment banks underwrite tax-exempt bonds.
 - No significant geographic barriers to competition exist.
 - Large firms compete for both large and small issues.
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MARKET DEFINITION

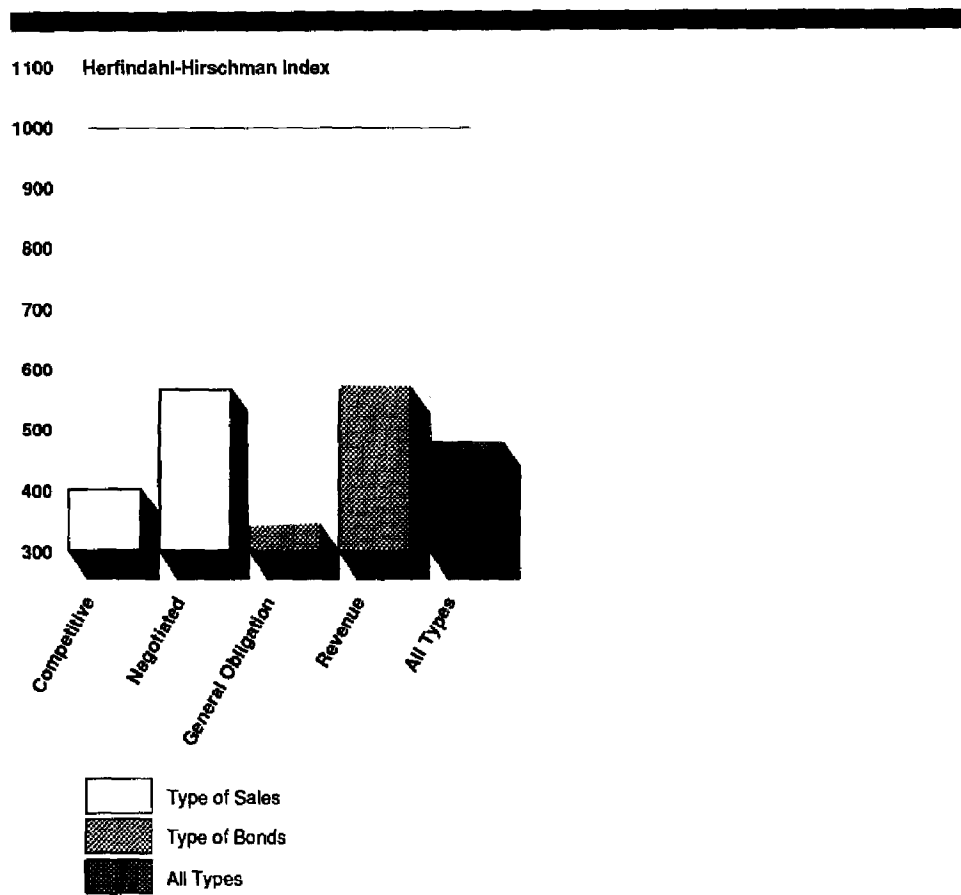
A market is defined in terms of a good or service and a geographic area. Large numbers of commercial and investment banks are able to underwrite tax-exempt bonds. We found that there are no geographic barriers to competition and that large national firms are actively competing for small as well as large issues. Therefore, it is unlikely that a local underwriting firm could consistently charge a significantly higher price without attracting competitors from outside the area. For the purpose of this analysis, we analyzed the tax-exempt bond underwriting industry on a national rather than local or regional level.

According to the Municipal Securities Ratemaking Board, approximately 300 commercial banks and 2,500 securities firms are registered to underwrite tax-exempt bonds. These firms can underwrite bonds nationwide, since there are no geographic barriers to competition.

To determine if underwriters are actively competing on issues of all sizes, we sampled bidding records from the Daily Bond Buyer on 233 competitive bond sales made during November 1988 through April 1989. On average, the bond issues received more than five bids. We found that the top 10 underwriting firms were involved in 41 percent of the bids made on all issues. The top 25 firms were involved in 69 percent of the bids. Eighty-eight percent of the issues received at least 1 bid from a syndicate containing a top 10 firm, and 92 percent of the issues received a bid from a syndicate containing a top 25 firm. For the 52 issues of between 1 and 2 million dollars, an average of over 5 bids were received. Eighty-three percent of these issues received a bid from a top 10 firm. This indicates that the largest firms were competing not only on the majority of issues, but also on the small issues. Therefore, local firms would be unlikely to be able to exercise monopoly power without inviting competition from national firms.

GAO Underwriting Industry Is Not Concentrated by Type

Figure I.4: Market Concentration of the Underwriting Industry



— Herfindahl-Hirschman Index: An industry with an index value of less than 1,000 is considered unconcentrated.

Source: GAO calculations based upon IDD information services/PSA Municipal Databases.

UNDERWRITING INDUSTRY IS NOT CONCENTRATED BY TYPE

If a small number of firms dominate an industry in terms of market share, it is more likely that monopoly or oligopoly profits can be sustained. If there are many sellers of the product, it is unlikely that any one seller could charge a higher price and maintain its market share.

The Herfindahl-Hirschman index is a commonly used measure of market concentration. The index is calculated by summing the squared market shares of the firms in the industry. The Department of Justice and the Federal Trade Commission will generally not oppose a merger between firms in industries where the computed index is less than 1,000. If the index is between 1,000 and 1,800, the industry is considered moderately concentrated; if the index is above 1,800, the industry is considered heavily concentrated.

As shown in figure I.4, the tax-exempt bond underwriting industry is not considered concentrated under Department of Justice standards. The index for all tax-exempt bonds issued in 1988 is 478--significantly less than the Department of Justice's 1,000 threshold. If the data are disaggregated by type of sale, type of bond, or by project type (negotiated bonds for education, housing, health care, public power, water and sewer, and transportation), the indices are still below 1,000. Therefore, it is unlikely that firms in the industry could charge excessive fees without losing market share.

GAO Barriers to Entry

- Glass-Steagall Act restricts commercial banks from underwriting certain types of tax-exempt bonds.
 - Issuers prefer to hire firms that have a proven track record in the origination of bond issues.
-

BARRIERS TO ENTRY

If potential competitors can enter a market easily, it is unlikely that monopoly profits could be maintained over time. If significant barriers to the entry of competitors are found, the existing firm(s) are more likely to sustain monopoly profits. In the case of tax-exempt bond underwriting, barriers include the legal exclusion of commercial banks from the underwriting of some types of revenue bonds and the importance of having an established reputation in the market in order to attract customers. These barriers do not appear to be significant, because the exclusion does not apply to the market as a whole, and the importance of reputation serves to slow, rather than preclude, entry into the market. Therefore, for the market as a whole, it is unlikely that firms could charge artificially high prices without attracting competitors.

Glass-Steagall Act

A barrier to the entry of new competitors in a segment of the municipal bond underwriting market is the legal restriction barring commercial banks from underwriting some types of municipal revenue bonds. The Glass-Steagall Act (sec. 16, 20, 21, and 32 of the Banking Act of 1933) limited the underwriting of revenue bonds to investment banks. In 1968, Congress amended the act to allow commercial banks to underwrite revenue bonds issued for certain university, housing, or dormitory purposes. This category, according to PSA, amounted to about 21 percent of revenue bonds in 1986. The Federal Reserve Board recently allowed subsidiaries of bank holding companies to underwrite certain investment grade revenue bonds, mortgage-related securities, commercial paper, securities backed by consumer receivables, and corporate debt, if revenues from underwriting these securities are not more than 10 percent of the subsidiaries' total revenues.

Reputation

According to several studies of the underwriting of corporate securities, a barrier limiting competition is the preference issuers give to firms having a track record in the management of syndicates and the origination of bond issues. The planning of a bond issue and the management of syndicates appear to be the areas where expertise is most valued by issuers, so the reputation of the firm is important. Since it takes time to develop a track record or reputation, it is more difficult for new firms to compete in these areas. In contrast, entry barriers are modest for firms whose role in a syndicate is limited to selling the bonds to investors.

GAO GFOA Views on Proposed Limits

- Issuance services are provided competitively.
 - Limits may lead to increased interest costs.
 - More information on cost of services would be beneficial.
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GFOA VIEWS ON PROPOSED LIMITS

Government Finance Officers Association members believe that the provision of issuance services is generally competitive and that the reduction in the volume of tax-exempt bonds issued after the Tax Reform Act has increased competition among underwriters. Accordingly, they see no need for the proposed limits on issuance costs.

GFOA members said that issuers have every incentive to minimize the total cost of issuing debt. The total cost of issuing debt includes the costs labelled as issuance costs and the interest cost of the bonds. Although the use of specialized services can increase issuance costs, these services can also help to reduce interest costs. For example, purchasing bond insurance would increase issuance costs, but the additional security backing the bond would lower interest costs, since investors would be willing to accept a lower interest rate for less risky bonds. The members also perceive quality differences among bond counsels and underwriters that are worth paying for if they lead to significantly lower interest costs. For this reason they said that limits on issuance costs would not necessarily save them money overall, since it could prevent them from obtaining the guidance and service needed to limit interest costs.

The members also expressed some concern about the lack of available information concerning typical issuance costs. For example, typical bond counsel fees are not readily available as are interest costs. The members would be interested in improving the quantity and quality of information on costs available to issuers as an alternative to limitations on costs. This could help them better select providers of issuance services.

GAO Issues Exceeding Proposed Limits Vary by Bond Type

Table 1.3:

Percent of Private Activity Bonds
Exceeding Proposed Limits
by Bond Type

<u>Bond type</u>	<u>1985</u>		<u>1986^a</u>	
	<u># Issues</u>	<u>Issues exceeding proposed limits %</u>	<u># Issues</u>	<u>Issues exceeding proposed limits %</u>
Student Loan	70	63	32	56
Qualified Mortgage	209	56	10	30
Private Exempt Entity	1,421	57	123	53
Industrial Development:				
Industrial Park	52	48	11	36
Small Issues	8,453	37	1,379	34
Residential Rental	1,935	68	105	59
Sports Facilities & Conventions	48	46	5	80
Airport	147	50	21	29
Sewer & Pollution	369	40	48	46
Water, Hydro, Mass	36	44	8	75
Commuting, Energy				
Other (bond type unknown)	7	14	26	4
Total	<u>12,747</u>	<u>44</u>	<u>1,768</u>	<u>37</u>

^aThe Tax Reform Act of 1986 placed a 2-percent limit (effective August 15, 1986) on the amount of bond proceeds that could be used to pay issuance costs. The 1986 data include only bonds issued before August 15, 1986.

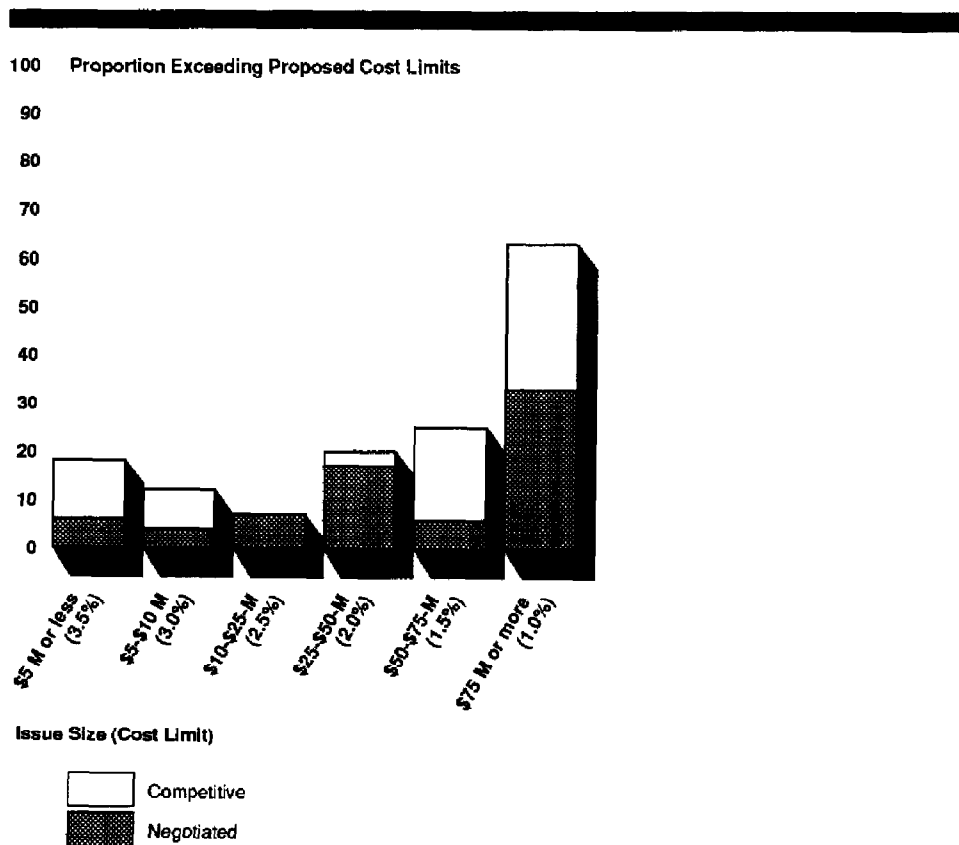
Source: GAO calculations based on IRS Form 8038 data.

ISSUES EXCEEDING PROPOSED LIMITS VARY BY BOND TYPE

We analyzed IRS data on private activity tax-exempt bonds issued in 1985 and 1986 to determine the number of bonds with issuance costs that would exceed H.R. 5350 limits. According to the proposed limits, bonds with issuance costs exceeding a specified percentage of total proceeds would not qualify as tax-exempt. The percentage limits range from 1 and 3.5 percent, depending on issue size. Our analysis showed that a high percentage of private activity tax-exempt bonds issued in 1985 and 1986 (44 and 37 percent respectively) would have exceeded the proposed limits. This is significant, since the proposed limits apply to all issuance costs regardless of how they are funded, and IRS data do not include issuance costs paid from funds other than bond proceeds. Table I.3 shows how the percentage of issues exceeding the proposed limits varies by bond type. IRS data on governmental bonds are not yet available.

GAO Issues Exceeding Proposed Limits Vary by Issue Size

Figure I.5: Percent of Issues Exceeding Proposed Cost Limits



Source: SUNY Albany, FMRC Preliminary Survey Results, April 4, 1989.

ISSUES EXCEEDING PROPOSED LIMITS VARY BY ISSUE SIZE

The preliminary results of the FMRC study of all types of tax-exempt bonds issued in 1988 showed that 20 percent (58 of 290) of all issues reporting underwriting spread had issuance costs that would exceed the proposed limits. Figure I.5 shows how the percentage of bonds exceeding the limits varies by size of issue and method of sale (competitive versus negotiated). The different percentages of bonds found above the limits in the FMRC survey and the IRS data on private activity bonds issued in 1985 and 1986 may be due to differences in the types of bonds in the samples and falling underwriting spreads from 1985 to 1988.

GAO Will Proposed Limits Restrict Ability to Issue Bonds?

How could some bonds that would exceed proposed limits still be issued?

- Provide services in-house
 - Change basis for fees
 - Allocate costs to other funds
 - Sell bonds to institutional investors
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WILL PROPOSED LIMITS RESTRICT ABILITY TO ISSUE BONDS?

Applying standard economic methods (pp. 28-35), we determined that the underwriting industry is relatively competitive. Given that fees in a competitive market reflect the cost of providing the services including a reasonable profit, it is unlikely that underwriters would reduce fees to ensure issuance costs were under the proposed limits and still provide the same level of service. If the proposed limits were enacted, however, their impact on tax-exempt bond activity might be mitigated by issuers and providers of issuance services looking for ways to redistribute or reclassify overall issuance costs to meet the limits. Some actions they could consider taking to keep bond costs within the limits include the following:

Services could be provided in-house

The Conference Committee Report for the Tax Reform Act of 1986 describes issuance costs as payments to outside persons for specialized services. The proposed limits give issuers an incentive to do the same work in-house, even if this leads to increased total costs. It may cost more to have staff do bond issuance work than to have outside specialists do the same job. Interest costs may also increase if more work is done in-house. For example, investors value an independent assessment of the legal form of the bond issue. Increased use of in-house legal staff rather than outside bond counsel could lead to increased interest costs as buyers may perceive the bonds as a riskier investment.

Change basis for fees

The manner in which issuers pay for some services could be changed if limits were placed on issuance costs. Underwriters and bond counsel are now generally paid on a contingent basis; firms recover their overhead costs only for bonds that are issued. If a planned issue falls through, generally out-of-pocket costs at most are recovered. Under a limitation on costs, fees could instead be billed on an hourly basis regardless of whether the bond was issued. As a result, cost per issue for attorneys and underwriters would be reduced by spreading charges across all potential issuers rather than only actual issuers.

Allocate costs to other funds

Additional rules defining issuance costs would be needed; otherwise, it might be possible to reclassify costs so they are not labelled as issuance costs. For example, issuers might employ bond counsel as general legal counsel and associate their fees with other non-bond-related activities.

Sell high issuance cost bonds
to institutional investors

The proposed limits could segment the tax-exempt bond market. Underwriters could reduce their selling costs for bonds with potentially high issuance costs by selling large blocks of bonds to institutions, such as mutual funds and insurance companies instead of individual investors. For bonds with potentially low issuance costs, underwriters could spend time and resources searching for individual investors willing to accept the lowest interest rate. Because these lower issuance cost bonds may not completely match the preference of individual investors, interest rates would have to be higher than they would otherwise. State and local governments would not necessarily benefit from lower issuance costs because they could pay higher interest costs as a result.

APPENDIX I

APPENDIX I

GAO Summary

- Issuance costs vary by bond type and size. Underwriter fees are the largest cost component.
 - Proposed limits could restrict state and local governments' use of tax-exempt financing.
 - Additional limits do not seem justified at this time.
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SUMMARY

Issuance costs typically include fees for underwriters, bond counsel, financial advisors, rating agencies, and printing services. Using various data sources, we found that issuance costs varied by the size of issue and by the type of project financed. Underwriters spreads are the largest type of issuance cost and have been falling since 1982.

Market share data indicate that the underwriting of tax-exempt bonds is relatively competitive by Department of Justice standards. Accordingly, the fees charged should reflect the costs of providing the services, including a reasonable profit. While commercial banks are excluded from underwriting some types of revenue bonds, this barrier to entry is not significant for the market as a whole. GFOA members believe that the provision of issuance services is generally competitive, although they expressed some concern about the lack of available information concerning typical issuance costs. While it is important to ensure that the subsidy of tax exemption is efficiently targeted to public purposes, the proposed limits on issuance costs do not seem to be justified at this time on economic grounds.

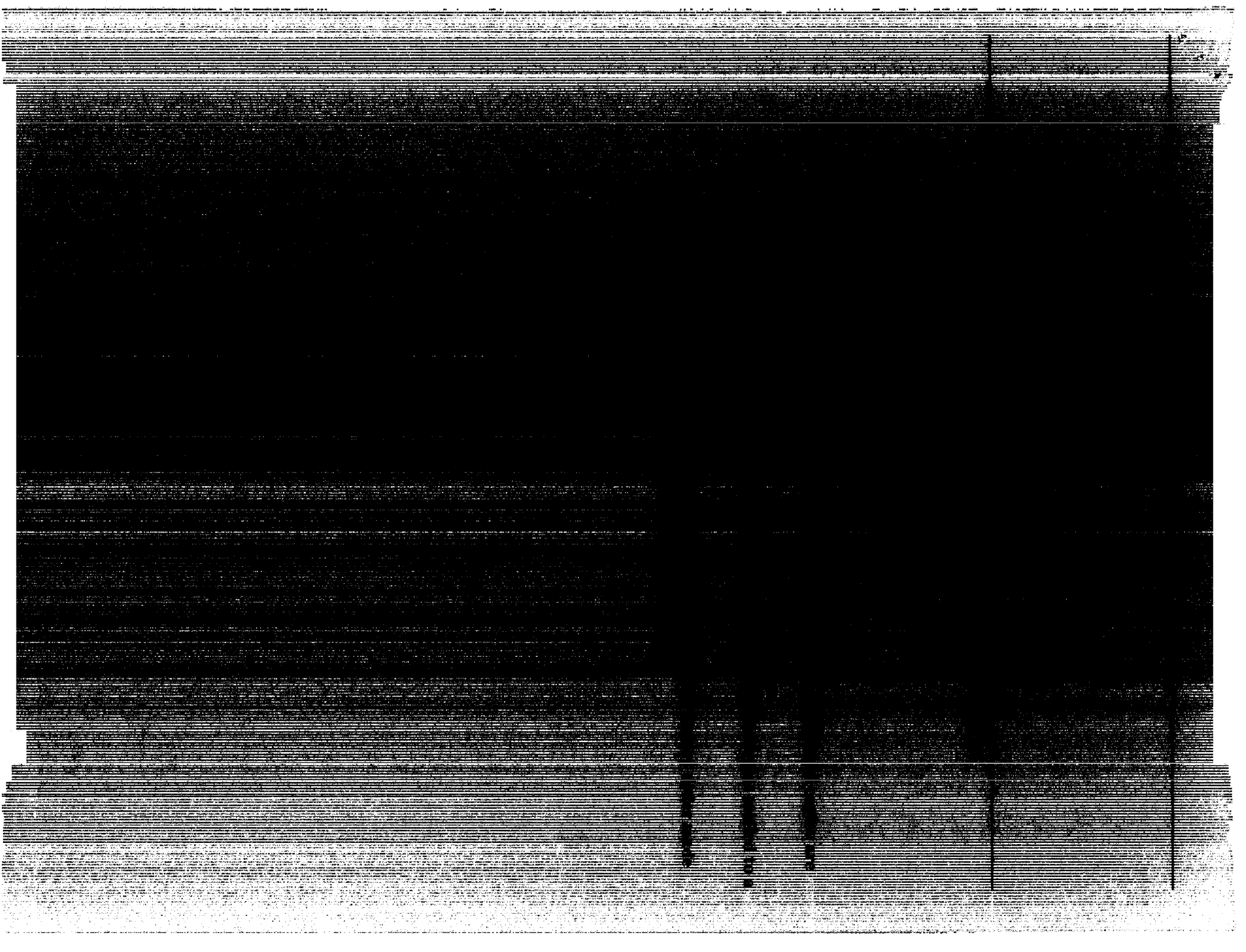
Both IRS and FMRC data indicate that significant percentages of tax-exempt bonds would have issuance costs above the proposed limits. The percentage would vary by type and size of issue. The proposed limits could restrict issuers' use of tax-exempt financing unless they found a way to redistribute or reclassify their issuance costs. Reducing issuance costs to meet the limits, however, could result in higher interest costs and/or in-house costs. Thus, issuers may not benefit from the reduction in issuance costs.

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