DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

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Dear Senator Tsongas:

A copy of the May 11, 1983 letter to the President from you and 19 of your Senate colleagues on the tax treatment of industrial development bonds (IDBs) and possible future limitations on IDBs has been sent to this office for review and comment.

The Administration has been concerned about the rapid and uncontrolled growth in the use of tax-exempt financing for private activities. IDBs, which are tax-exempt bonds issued by State and local governments for the benefit of private businesses, have accounted for a large percentage of this growth in recent years. Other private purpose bonds include mortgage subsidy bonds and student loan bonds. Their volume also has increased dramatically. Treasury estimates that private purpose tax-exempt bond issues in 1982 totalled $44 billion, which accounted for over one-half of all long-term tax-exempt bond issues. Even after enactment of the restrictions imposed in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the rapid growth of private purpose bonds can be expected to continue. If the sunset on mortgage subsidy bonds is extended, we estimate that total private purpose tax-exempt bond volume will reach $57 billion in 1984 and $67 billion in 1985.

The uncontrolled growth of private purpose tax-exempt bonds is disturbing for several reasons. First, the large volume of private purpose bonds exerts upward pressure on tax-exempt interest rates. The relative advantage of tax-exempt bond financing has fluctuated greatly, as your letter indicates. However, if other factors remain constant, an increase in the volume of tax-exempt bonds will cause tax-exempt interest rates to rise. The enormous volume of private purpose bonds has raised interest costs for traditional public projects, such as roads, sewers, and schools, above what they would have been in the absence of private purpose bonds.

Furthermore, we are concerned because tax-exempt financing is an inherently inefficient subsidy. A very large portion of the benefit of the tax exemption (more than one-third, in the case of typical long-term bonds) flows to the bond investors, rather than to the users of the bond proceeds.

Finally, substantial revenue losses have resulted from the use of tax-exempt financing for private businesses and other private purposes. The total revenue loss from private purpose tax-exempt bonds in fiscal year 1983 is estimated to be at least $5.8 billion. Although IDBs may increase employment and tax receipts in a local jurisdiction issuing IDBs, they are unlikely to increase national income and employment because their primary effect is to redistribute jobs among local jurisdictions, and because the cost of the Federal IDB subsidy must be financed through spending reductions, tax increases, or Federal borrowing.

In 1982, as part of the President's fiscal year 1983 budget, the Administration proposed legislation that would have restricted the growth in volume of private purpose tax-exempt bonds. Congress enacted some of the Administration's proposals in TEFRA, but it did not go as far as the Administration proposed. As previously mentioned, the volume of private purpose bonds will continue to increase rapidly, despite the TEFRA limitations.

The Administration has not made a comprehensive legislative proposal relating to private purpose tax-exempt bonds for this fiscal year. Nevertheless, Treasury continues to believe that serious consideration should be given to some form of comprehensive limitation on the uncontrolled growth of private purpose tax-exempt financing, including IDBs.

For example, in testimony concerning proposals to extend the existing mortgage subsidy bond program, the Treasury Department suggested that a State-by-State volume limitation might be imposed on all tax-exempt bonds for private purposes (including IDBs and mortgage subsidy bonds). This type of volume limitation would restrict the maximum amount of private purpose bonds that could be issued within each State, but would leave the decision as to what kinds of projects should receive tax-exempt financing to the State and local governments. The Treasury Department also has testified in support of H.R. 1635, a bill introduced by Representative Pickle, which proposes tax-exempt bond reforms similar to those proposed by the Administration in 1982.

In supporting these proposals, it is important to note that the Administration does not advocate elimination of all IDB financing. Rather, our support reflects a strong belief that some form of meaningful limitation on this Federal subsidy program is necessary. State volume restrictions or the provisions of H. R. 1635 are two valid approaches to limiting the volume of private purpose financing. There may be other approaches that deserve consideration.

Thank you again for your interest in this matter.

Sincerely,

John E. Chapoton

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