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Tax-Exempt Bond Provisions in the "Economic Growth and Tax Relief Reconciliation Act of 2001"

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Summary

This short report describes and analyzes three provisions included in P.L. 107-16. Two of the three provisions will likely induce more tax-exempt bond financing for public school capital investment through loosening arbitrage bond rules for some issuers and expanding the list of otherwise private facilities that are still eligible for tax-exempt financing. Specifically, Section 421 of P.L. 107-16 modifies rules on arbitrage rebate bonds and Sec. 422 expands the definition of private activity bonds. The third provision, lower marginal tax rates (Section 101), will decrease the demand for tax-exempt bonds. The total effect of P.L. 107-16 on the tax-exempt bond market may be generally higher tax-exempt bond interest rates. This report will be updated if new information becomes available.

Introduction

State and local governments can issue tax-exempt government bonds for school construction and other purposes. However, to maintain tax-exempt status, the bonds must comply with Internal Revenue Service regulations governing the use and purposes of tax-exempt bonds. The 2001 tax cut bill, P.L. 107-16, had two provisions designed to make it easier for state and local governments to comply with these rules.[1] This short report provides background information on the two types of bonds affected by the legislation and describes the new tax-exempt bond provisions and their likely effects on public school construction and interest rates.

[1] A more expansive review of the major components of the legislation is available in CRS Report RL30973 *Tax Cuts: A Side-by-Side Comparison of the President's Proposal and the House, Senate, and Conference Bills.*

Background

Individual and corporate investors who buy federally tax-exempt state and local government bonds do not have to pay federal income taxes on the interest payments from the issuer. This tax exclusion enables the issuers to sell bonds with a lower interest rate than if the bonds were taxable. A rough approximation of the size of the federal subsidy is the difference between the taxable bond interest rate and the tax-exempt bond interest rate multiplied by outstanding tax-exempt state and local debt. According to this calculation, the subsidy was about $18.1 billion in FY1998.[2]

However, the subsidy to state and local government does not necessarily equate to the federal revenue loss. The reason for this is that the federal revenue loss is dependent on the marginal tax bracket of the bondholder. For example, exempting $100 of interest income for an individual in the 28% bracket costs the federal government $28; for a corporation in the 35% bracket it costs the federal government $35. Thus, the revenue loss changes depending on marginal tax rates generally and indirectly on the income of tax-exempt bondholders. The Joint Committee on Taxation estimates that the federal revenue loss from exempting interest on state and local government bonds will be $23.7 billion in FY2001.

P.L. 107-16 expanded the subsidy and the federal revenue loss through two provisions. The first, Section 421, modifies the definition of small issuer with regard to arbitrage bonds. The second, Section 422, modifies the definition of what qualifies as a tax-exempt facility, private activity bond. Following is an explanation of arbitrage bonds and private activity bonds.

Arbitrage Bonds. Bonds are called taxable arbitrage bonds if a governmental unit, in violation of the arbitrage restrictions in the tax code, invests a substantial portion of the proceeds "to acquire higher yielding investments, or to replace funds which were used directly or indirectly to acquire higher yielding investments."[3] If state and local governments had unlimited capacity to issue debt at low interest rates and use the bond proceeds to buy higher-yielding taxable debt instruments, state and local governments could substitute arbitrage earnings for general tax revenue.

Congress decided in the late 1960s that such arbitrage activity is unacceptable and that tax-exempt bond proceeds must be used as quickly as possible to pay contractors for the construction of capital facilities for which the bonds were issued. Since it is impossible for bonds to be sold precisely when contractors must be paid for their services, the tax law does provide a two-year period for state and local governments to spend-down bond proceeds. Bond issues that have unspent proceeds in excess of the allowed amounts during this two-year spend-down schedule must rebate any arbitrage earnings to the U.S. Department of the Treasury.

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[2] In 1998, the interest rate difference between high-grade corporate bonds and tax-exempt municipals was 1.41% and the total debt outstanding was $1.3 trillion. Source of debt outstanding is the U.S. Census, Census of Governments Division, at the following Web site: [http://www.census.gov/govs/estimate/9800us.html].

[3] 26 I.R.C. Section 148(a).

Private Activity Bonds. Bonds are considered to be for a public purpose if they satisfy either of two criteria: less than 10% of the proceeds are used directly or indirectly by a non-governmental entity; or less than 10% of the bond proceeds are secured directly or indirectly by property used in a trade or business. Bonds that satisfy either of these tests are termed "governmental" bonds and can be issued without federal limit. Bonds that fail both of these tests are termed "private-activity" bonds because they provide significant benefits to private individuals or businesses. In general, these projects and facilities are ineligible for tax-exempt financing. However, some federally designated facilities and projects that fail the governmental purpose test can qualify for tax-exempt financing. These bonds are called *tax-exempt* private activity bonds.

Under current law, the amount of tax-exempt private activity bonds that each state can issue in any one year is limited to the greater of $62.50 per resident or $187.5 million in 2001. In 2002, the limit increases to the greater of $75 per resident or $225 million. Beginning in 2003, the limit is adjusted for inflation. Private activities qualify for tax-exempt bond financing if they are in section 141(e) of the Internal Revenue Code. The bonds for those private activities are classified as (see Table 1 for the volume of bonds for each type of activity):

- exempt facility bonds[4],
- qualified mortgage bonds,
- qualified veterans' mortgage bonds,
- qualified small issue bonds,
- qualified student loan bonds,
- qualified redevelopment bonds,
- or qualified 501(c)(3) bonds.

Table 1. Private-Activity Bond Volume by Type of Activity

($ in millions)

Private Activity	Issued in 2000	Percent of Available Capacity in 2000
Capacity for 2000	$15,375.7	
Carryforward from Prior Years	3,766.5	
Available Capacity	$19,142.2	100.0%
Single-family Mortgage Revenue	3,636.0	19.0%
Multi-family Housing	3,041.1	15.9%
Industrial Development	3,008.3	15.7%
Housing not Classified	1,594.0	8.3%
Student Loans	1,562.4	8.2%
Exempt Facilities	1,427.7	7.5%
Other Activities	715.3	3.7%
Mortgage Credit Certificates	436.2	2.3%
Carry Forward (unused capacity)	3,615.0	18.9%
Abandon Capacity	106.6	0.6%

Source: "State Allocation of Private-Activity Bonds in 2000," *The Bond Buyer*, July 9, 2001, p. 34.

[4] Exempt facility bonds are discussed further on page 4.

The large portion of "carry-forward" or unused bond capacity may be misleading. Many states "save" bond capacity for large projects that would exceed the annual limit if the project were financed in a single year. Or, some states may wish to wait for more favorable market conditions to sell their bonds. Thus, even though it may appear the volume cap is not restricting, most states eventually use most of their capacity. The amount of "abandon capacity" was just .6% of total available capacity in 2000.

Details of Tax-exempt Bond Provisions in P.L. 107-16

Section 421. Additional Increase in Arbitrage Rebate Exception for Governmental Bonds Used to Finance Educational Facilities. Before enactment of P.L. 107-16, excess arbitrage earnings from tax-exempt bonds were required to be rebated to the federal government. However, bonds issued by qualified small governmental units were exempt from arbitrage rebate constraints. Before enactment of P.L. 107-16, a qualified small governmental unit was one that issued less than $10 million of debt per year, and at least $5 million of the debt was used for public school construction. If the governmental units do not have school construction debt, they could have issued up to $5 million and still qualify as a small issuer.

The new law, which goes into effect for bonds issued after December 31, 2001, increases the limit to $15 million and the school construction portion increases from $5 million to $10 million. Thus, a governmental unit with a $15 million annual debt issuance – at least $10 million of which is for school construction – will now qualify as a small issuer. The newly qualified small issuers will avoid the arbitrage rebate requirement.

Analysis. Doubling the arbitrage rebate exception for school construction from $5 million will allow more small issuers to bring bond issues to market and increase arbitrage profits. In addition, because monitoring arbitrage rule compliance can be costly for the issuing government, allowing more issuers to sell their bonds without worrying about arbitrage compliance should allow those issuers to sell their bonds at a lower interest rate.

The intent of the arbitrage restrictions is to limit the federal revenue loss resulting from state and local government issuance of tax-exempt bonds. Loosening the arbitrage restrictions exposes the federal government to potentially greater revenue losses. However, proponents of the legislation cite the administrative burden the arbitrage restrictions impose on small issuers and the relatively small revenue loss potential presented by small issuers. Proponents contend that loosening arbitrage restrictions for small issuers and lowering their borrowing costs more than outweigh the anticipated increase in the federal revenue loss.

Section 422. Treatment of Qualified Public Educational Facility Bonds as Exempt Facility Bonds. This provision expands the definition of "an exempt facility bond" to include bonds issued for qualified public educational facilities. The qualified public educational facilities are in addition to the existing 12 types of exempt facilities.[5] Exempt facilities are typically large public works, such as solid waste disposal

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[5] The other 12 types are: 1) airports; 2) docks and wharves; 3) mass commuting facilities; 4) facilities for the furnishing of water; 5) sewage facilities; 6) solid waste disposal facilities; 7) (continued...)

facilities and water furnishing facilities, which often receive some mix of private investment and public assistance. The new bonds for public educational facilities share this partnership feature with existing exempt facility bonds. A qualified public educational facility is defined in the Act as any school facility which is:

> (A) part of a public elementary school or a public secondary school, and (B) owned by a private, for-profit corporation pursuant to a public-private partnership agreement with a state or local educational agency (LEA)....[6]

A satisfactory public-private partnership agreement is one where the private entity agrees to do one or more of the following: construct, rehabilitate, refurbish, or equip a school facility. At the end of the agreement, the private entity must transfer the school facility to the LEA for no additional consideration.

A school facility is "...any school building, any functionally related and subordinate facility and land with respect to such building, including any stadium or other facility primarily used for school events...."[7] This broad definition of school (or educational) facility allows the proceeds of the bonds to be used for nearly any school-related capital investment, including sports stadiums.

Unlike most other exempt-facility bonds, bonds issued for qualified educational facilities are not counted against a state's private-activity volume cap. However, the qualified public educational facility bonds have their own volume capacity limit equal to the greater of $10 multiplied by the State population or $5 million. Since nearly all states are better off with the $10 per capita limit, the potential new debt would have been approximately $2.8 billion in 2001 based on 2000 population. In 2000, exempt facilities subject to the limit consumed 7.5% of the private activity volume cap or $1.4 billion (see Table 1).[8] Thus, the new public educational facilities bonds could significantly increase the volume of tax-exempt debt that falls outside of the capacity limit.

Analysis. The expansion of tax-exempt bond financing to include public educational facilities and creating an independent volume cap will lead to a larger loss of federal revenue from tax-exempt financing. However, the loss in federal revenue is not the only consequence of the new law. The new law will also induce a shift from other investments to those financed with tax-exempt bonds and will lead to an increase in supply of tax-exempt bonds generally. In addition, other components of P.L. 107-16, not directly related to tax-exempt bonds will influence the bond market.

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[5] (...continued)
qualified residential rental projects; 8) facilities for the local furnishing of electric energy or gas; 9) local district heating or cooling facilities; 10) qualified hazardous waste facilities; 11) high-speed rail facilities; and 12) environmental enhancements of hydroelectric generating facilities.

[6] Section 422(b) of P.L. 107-16 or 26 U.S.C. Section 142(k)(1).

[7] Section 422(b) of P.L. 107-16 or 26 U.S.C. Section 142(k)(3).

[8] Before enactment of P.L. 107-16, three of the 12 types of exempt facilities were not subject to the cap: airports; docks and wharves; and environmental enhancements of hydroelectric generating facilities. A fourth, high-speed rail facilities, is partially exempt from the volume cap.

Tax-exempt bonds, by their nature and intent, shift investment from non-tax-favored activities to those financed with tax-favored bonds. In theory, investors choose the investment with the highest relative return. Before the new legislation became law, capital investment in public schools owned and operated by private corporations was apparently unattractive relative to other investment options, leading to relative under-investment in public school infrastructure. Privately owned and operated schools likely borrowed at the taxable rate and perhaps paid an interest rate premium to reflect the greater risk of the private entity defaulting on their bonds. (Some private entities are allowed to issue tax-exempt bonds for school construction, such as a qualified 501(c)(3) organizations; these entities will not be directly affected by the new legislation.)

After the new law takes effect, some of these private issuers will be able to sell tax-exempt bonds. Investment in the now more attractive public educational facility bonds will likely come at the expense of other types of bond investment options. For example, if the perceived risk of default is greater for the existing 501(c)(3) bonds than for the new public educational facility bonds (which are both tax-exempt), investors will shift away from 501(c)(3) bonds to the safer public educational facility bonds.

More generally, the increase in the supply of tax-exempt bonds will likely lead to an increase in the interest rate of all tax-exempt bonds. In markets, when the supply of any product increases without a change in price, suppliers in that market will try to make their product more attractive to the buyer. For commodities, the price is lowered; for bonds, the interest rate is increased (or the purchase price falls below face value, i.e. the bond sells at a discount). Thus, when the supply of bonds increases, the interest rate also increases, all else equal. Higher interest rates make debt finance more costly.

Section 101. Reduction in Income Tax Rates for Individuals. Finally, another component of P.L. 107-16 that affects the tax-exempt bond market is the across-the board reduction of marginal income tax rates. Lower marginal income tax rates are expected to reduce the demand for tax-exempt bonds because the benefit derived from sheltering income from taxes is not as attractive when marginal income tax rates are lower. For example, exempting $100 of interest income for an individual in the 28% bracket is worth $28 to the taxpayer. If the marginal income tax rate drops to 25%, the benefit is worth only $25.

Analysis. The potential drop in demand for tax-exempt bonds would likely lead to upward pressure on tax-exempt bond interest rates. Returning to the market example, if the demand for any product declines, the seller would likely lower prices to make the product more attractive to potential buyers. Again, in the bond market, sellers would increase the interest rate to make the bonds more attractive.

Concluding Observation

In theory, the increase in supply and drop in demand for tax-exempt bonds induced by P.L. 107-16 will together lead to upward pressure on tax-exempt bond interest rates. The increase in interest rates may then raise the cost of tax-exempt bond financing for state and local governments in general. However, the cost of financing school construction in particular may decline relatively and/or absolutely.