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Removal of the Tax Exemption Privilege for Interest on Municipal Industrial Bonds

Borrowing by municipalities or their instrumentalities to finance acquisition, construction, or improvement of industrial facilities to be leased to private industry is increasing. Additional States are authorizing their municipalities to engage in such borrowing as a method of attracting industry.

Volume and Geographical Distribution of Industrial Bonds

More than $185 million of municipal industrial bonds were issued in the period 1951-1961, and a large proportion of this financing ($137 million) has occurred in the five years 1957-1961. Reported sales are shown by years in the accompanying table.

Since 1936, the year in which Mississippi authorized the issuance of bonds by municipalities for development of industrial facilities, nearly 300 cities, counties, and municipalities in eight States (largely in the South) have issued tax-exempt bonds to provide plant facilities for use by private firms.

The success of the Mississippi program in attracting industry has led to the adoption of similar plans by 21 other States. About one-half of these permit the issuance of general obligation bonds backed by the full faith and credit of the issuing authority. In most of these States, however, with the exception of Mississippi, the bonds which have been issued are not a liability of the issuing authority but are revenue bonds repayable from the rental payments of the industrial plant. In effect, the municipality's _imprimatur_ is simply used to obtain lower interest rates for the benefit of a private firm.

Issues Raised by Municipal Industrial Bond Financing

Although municipal industrial financing accounts for only a very small proportion of the total State and local bonds issued, the propriety of using the tax exemption privilege for this purpose has been questioned by a number of groups representing varied interests, including the Investment Bankers Association, the Municipal Finance Officers Association, the U.S. Chamber of Commerce, AFL-CIO, and the Municipal Law Section of the American Bar Association. The Investment Bankers Association considers such financing a misuse of public credit for the benefit of private industry which may jeopardize the continuation of the Federal income tax exemption for all State and municipal bonds. Representatives of the municipal governments also fear the effect on the tax exemption privilege in general. Business groups and labor unions criticize the practice on the grounds of unfair competition among businesses and the effect on the migration of industry.

1. Benefits derived by private business

The municipal industrial bond financing techniques used to attract industry take advantage of the tax-exempt feature of municipal bonds. Because of the exemption feature these bonds generally are issued at a lower rate of interest than would be required for borrowing by a business. The lower borrowing costs make it possible for a municipality to reduce the cost of constructing a plant and this saving is passed on to the private lessee in the form of lower rental payment. In most States, the municipality retains title to the building until the bonds are retired, thus exempting such property from local property taxes. Also, these bonds can be purchased by the lessee, thus giving the company the advantages of tax-exempt interest together with the deduction of rental as an operating expense. The attached copy of an advertisement in the Wall Street Journal illustrates these benefits.

2. Effect on competition and migration of industry

The use of municipal industrial bonds has also been criticized on the ground that companies which take advantage of these bonds obtain an unfair competitive advantage at the expense of the Federal Treasury. The labor unions complain that migration of industrial activity from one location to another in order to take advantage of industrial facilities subsidized in this way leaves workers stranded in communities which may find it difficult to adjust to the loss of industry. As an example of such migration, the Norge Division of Borg-Warner Corporation recently moved from Muskegon, Michigan to a new plant financed by a $7.5 million bond issue of Greenwood, Arkansas. This transfer caused a loss of about 1,800 jobs in Muskegon.

3. Use of the public credit for private purposes

The Supreme Court of Florida has held unconstitutional the issuance of bonds to finance construction of industrial plants to be leased to private companies. While recognizing that such bonds promote the general development of the area by furnishing employment, and, therefore, may serve a "public" purpose, the court stated that the principal purpose of such bonds is to use the public credit for the benefit of a private corporation.

On the other hand, the courts in other States have upheld the constitutionality of such bond issues. The Supreme Court of Tennessee, for example, in upholding the validity of the use of public credit to attract industry for the purpose of providing employment stated that it is clearly a "public" purpose for the State or local government to provide against such evils as unemployment and resultant low wages by any method or means not prohibited by the Constitution, State or Federal.

Proposals

Two methods of restricting the use of the tax exemption privilege of municipal industrial bonds have been proposed: (1) denial of the deduction of rental to private companies occupying plants financed by municipal bonds or (2) elimination of the exemption with respect to interest on bonds issued to provide facilities for private use.

The Investment Bankers Association favors the first approach. In 1954, the House of Representatives approved adoption of this approach, but limited it to revenue bonds. The Senate Finance Committee rejected this provision.

The major difficulty with the rental approach is that municipalities and businesses could evade it by such devices as sale of the facility to the private enterprise with the municipality holding the mortgage. The corporation could then deduct interest instead of rental.

Both of these approaches were proposed in legislation introduced in the 87th Congress. H. R. 6368, introduced by Representative Griffin, would deny deduction of rentals for use or occupancy of an industrial plant acquired or improved out of proceeds of a tax-exempt obligation. H. R. 798, introduced by Representative Multer, proposed denial of tax exemption of interest on State and municipal revenue bonds used to finance facilities to be operated by non-public enterprises. S. 2042, introduced by Senator McNamara, would have denied the exemption with respect to any obligations issued to finance facilities "to be used by any person, other than the Government issuing such obligations, in the conduct of any trade or business for profit."

Elimination of the exemption of interest on bonds issued to provide facilities for private use would not impinge upon the sovereignty of State and local governments and would not affect their borrowing for public purposes.

Attachments

Office of the Secretary of the Treasury
Office of Tax Analysis

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