TO: File DATE: November 14, 1985

FROM: Jon Hakken J.H. and Daphne Kenyon DK

SUBJECT: Meeting with Council of Industrial Development Bond Issuers Study Team

On November 8 we met with Kevin McCarty, Mike Zamba, Art Domike, Gary Hufbauer, Larry Eastland and William Castner to discuss our comments on their recent report: "Small Issue Industrial Development Bonds and the U.S. Economy".

We focused on what we believe to be the two major errors in the report, errors which are largely responsible for their conclusion that "Federal revenue losses associated with small issue IDBs have been persistently overstated in past estimations. Using conservative assumptions, elimination of SIDBs would have a negligible impact upon the federal deficit; using more realistic assumptions, eliminating SIDBs would cause federal revenues to shrink."

Jon explained his disagreement with a key part of their static revenue loss estimate--their use of an estimate of the marginal tax rate of commercial banks rather than of the average marginal tax rate of households holding tax-exempt bonds. They justify this choice by presenting evidence that commercial banks are the predominant holders of small issue IDBs, and concluding from this that the market for small issues is separate from the rest of the tax-exempt bond market. Jon explained that the individual investor is still the marginal buyer of tax-exempt bonds. Because banks aim to zero out their tax liability, their demand for tax-exempt bonds is inelastic. Because of inside information on SIDB quality, banks are expected to be their major purchasers, but given inadequate supply of SIDBs, banks will hold other tax-exempts. Any increase in SIDB availability will cause commercial banks to buy more SIDBs, reduce the portion of other tax-exempts in their portfolio, which will then be purchased by individuals. We came to no agreement on this issue with the study team, which held firm that small issues create no general equilibrium effects, but are merely substitutes for equivalent commercial lending.

Next, Daphne concentrated on the alleged revenue reflows, which according to the study make SIDBs a source of additional federal revenue rather than a source of revenue loss. First, Daphne maintained that an evaluation of SIDBs did not appropriately include an examination of their macroeconomic impact. They are not a tool of macroeconomic policy--they are too small in size to have more than a negligible effect on the entire economy and they cannot be used in a countercyclical manner. In addition, a direct spending program in lieu of SIDBs would also have effects on investment, employment and GNP. If the macro effects of SIDBs are going to be examined, they should be compared to the macro effects of alternative policies.

Further, the report does not make a sufficient case that SIDBs would increase savings, which is necessary in order to increase investment assuming a revenue-neutral package. The information provided on additional investment came from survey data, which Daphne argued is a poor source. Respondent information on additional investment induced by SIDBs is going to be flawed because it is in their best interest to inflate the magnitude of their own additional investment and because they will have no knowledge of other investment projects foregone because capital was diverted from its next best alternative use (i.e., the invisible hand is invisible). Finally, the report does not take into account the possibility that SIDBs, by distorting the use of capital, can actually be reducing GNP. One member of the study team agreed that perhaps an analysis of the macro effects of SIDBs should not have been included, but that the most important effect of small issues was to channel investment to areas of high unemployment. They argue that capital is already misallocated, that too little goes to areas of economic decline, and that SIDBs encourage banks to improve capital allocation by increasing lending in these areas. Although we do not agree with their capital misallocation argument, sufficient empirical evidence is not available to support either their view or ours.

cc:

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