THE POLITICAL ECONOMY OF CORPORATE WELFARE: INDUSTRIAL REVENUE BONDS

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Since the mid-1930s state and local governments have issued tax-exempt "industrial revenue bonds" (IRBs) to finance selected business enterprises. The original argument for the creation of IRB tax exemptions is the same as that for their present day continuation: Private capital markets allegedly "fail" to provide adequate financial resources to many firms, especially small businesses, and this inadequacy reduces the economy's productive capacity and exacerbates unemployment. Each state, and nearly every major local government, now has an "industrial development agency" which sells IRBs. Although it is impossible to gauge accurately the total volume of IRB sales, since many are privately negotiated, the Congressional Budget Office estimated total sales to exceed $10 billion in 1981.

This paper assesses the likely effects of the IRB finance on the allocation of resources. The second section discusses the development of IRB finance followed by a brief description of the activities of industrial development agencies in the third section. The fourth and fifth sections examine the rhetoric and reality of industrial development agencies and demonstrate that they are more likely to reduce the economy's productive capacity than enhance it and to distort the market process. The final section contains a summary and conclusions.

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The Development of Industrial Revenue Bond Finance

State and local governments issue two types of debt: general obligation bonds, which are backed by "the full faith and credit" of the issuing government and serviced with tax revenues; and revenue bonds, which are not guaranteed and are serviced by user charges from projects to be financed and from intergovernmental grants. During the late 19th century profligate general obligation borrowing practices by state and local governments led to frequent defaults and financial crises. Consequently, state statutory and constitutional restrictions on local government debt were imposed which placed limits on the amount of general obligation indebtedness as a percentage of the tax base, required referenda for bond issuance, restricted debt maturity dates (usually 20 years), and established interest rate ceilings.

To circumvent these restrictions, revenue bonds were adopted by local (and state) governments. Revenue bonds are generally issued by various public enterprises, the borrowing, spending, and employment of which are not included in the budget of the jurisdiction which created the "off-budget enterprise" (OBE). One of the first OBEs was the Port Authority of New York and New Jersey which was modeled after the Port of London Authority. There are now over 10,000 OBEs at the local level of government in the United States and thousands more at the state level.[1]

In 1936 Mississippi became the first state to permit local governments to create a particular type of OBE, the industrial development agency (IDA), for issuing tax-exempt industrial revenue bonds to finance private businesses. In contrast to "industrial development bonds," which may be backed by the "full faith and credit" of the issuing government and are therefore on budget and voter approved (although used much less frequently than IRBs), the only backing for IRBs is the credit of the borrowing firm, the revenue from projects financed and operated by the firm, or the firm's facilities. If the borrower defaults, the bondholder bears the loss. Since interest income from IRBs is tax exempt, private businesses can borrow at below market interest rates.

By 1960, 17 states permitted the use of IRBs. Twenty-five additional states passed IRB-enabling legislation during the 1960s, and

[1]For a discussion of off-budget enterprises see Annmarie H. Walsh, *The Public's Business: The Politics and Practices of Government Corporations* (Cambridge, Mass.: MIT Press, 1980).

the volume of reported IRB sales rose by 1,700 percent between 1960 and 1968, from $100 million to $1.8 billion.[2] In 1968 IRBs constituted approximately nine percent of long-term, tax-exempt municipal security sales compared with just one percent in 1960. This increase was due largely to the rise in issue size, which grew from an average of $360,000 in 1957 to $7.8 million in 1967. Large corporations had come to realize the usefulness of IRBs in financing investment projects. For example, between 1962 and 1968 all major tire manufacturers (Armstrong, Cooper, Dunlop, Firestone, Goodrich, Goodyear, Mansfield, Mohawk, Uniroyal) used IRB financing, as did many other large manufacturers.[3] Critics of IRB financing soon began to levy charges against these companies: They used "public funds" to subsidize projects that would have been undertaken without subsidies; the projects resulted in revenue losses to the treasury; and they led to an increase in state and local borrowing costs. The Congress was sympathetic to these views and in 1968 passed the Revenue Expenditure and Control Act which intended to limit IRB use. The act withdrew the tax exemption for all but a number of exceptions such as air and water pollution control equipment, airports, docks, wharves, electricity, gas and water services, industrial parks, parking, mass transportation, housing, sewage, sports facilities, and trade shows and convention centers. The act also exempted bonds with a face value not exceeding $5 million to finance plants and equipment for industrial facilities. The purpose of this exemption was to change the focus of IRB finance so as "to assist *small* businesses in locating in a community"[4] (emphasis added).

In 1978 President Carter, anxious to expand the Urban Development Action Grant (UDAG) program, proposed that the limits for "small-issue IRBs," often used in combination with UDAG grants, be raised to $10 million. Congress complied and the higher limit went into effect on January 1, 1979.

Measuring the current volume of IRB sales is virtually impossible, since most IRBs are small issues which are negotiated with local banks and need not be reported to the Securities and Exchange Commission. Nevertheless, some estimates have been made, and the most reliable are probably those of the Congressional Budget Office which surveyed IRB-issuing agencies in each state.[5] These estimates

[2]Congressional Budget Office, *Small Issue Industrial Revenue Bonds* (Washington, D.C.: CBO, April 1981), p. 9.

[3]Ibid.

[4]Wilbur D. Mills, *Congressional Record*-House, October 10, 1968, p. 30603.

[5]Congressional Budget Office, p. 14.

are shown in Table 1 and remain underestimates since some states do not maintain records of IRB sales. Even with these data limitations it is clear that IRB sales have grown dramatically, having increased by 546 percent between 1975 and 1980.

The Industrial Development Agency

The conduit through which IRBs are issued is the industrial development agency, which exists at both the state and local levels of government. Each state has established at least one IDA at the state level of government. In recent years the activities of IDAs have expanded substantially, as is evidenced by the rapid increase in IRB sales and the fact that total agency budgets increased by over 300 percent during the 1966–73 period, from $2.57 to $7.63 million.[6]

At the local level of government IDAs are established by local governments and managed by governing bodies comprised of at least five political appointees who are usually local politicians or professional "urban planners." A key role is played in IRB financing of private businesses by "local industrial development corporations" (LIDCs). LIDCs are "non-profit" corporations formed by local business interests. Their purpose and role in the IRB-financing process has been succinctly stated by the Council of State Governments:

> Many . . . industrial finance authorities do not make loans directly to industrial prospects. In these states the LIDC serves as a bridge

TABLE 1

ESTIMATES OF THE VOLUME OF SMALL ISSUE INDUSTRIAL REVENUE BONDS: 1975–1980
(billions of dollars)

Year	Congressional Budget Office	Public Securities Association	Daily Bond Buyer
1975	$1.3	$0.5	$0.5
1976	1.5	0.4	0.3
1977	2.3	0.8	0.5
1978	3.5	0.9	0.6
1979	7.1	1.7	1.3
1980	8.4	1.6	1.4

SOURCE: Congressional Budget Office, *Small Issue Industrial Revenue Bonds* (Washington, D.C.: CBO, April 1981), p. 14.

[6]Institute of International Law and Economic Development, *The Industrial Revenue Bond As a Financial Attraction Device* (Washington, D.C.: Economic Development Administration, 1978), p. 144.

between the authority and the new industry. In some states this procedure is necessitated by constitutional provisions prohibiting the loan of public monies to private industry. The LIDC, as a non-profit corporation, however, can hold title to industrial property and receive the loan.[7]

The Rhetoric and Reality of Industrial Development Finance

Although many states outlaw the practice of tax exemptions for selected private firms or individuals, IRBs have always survived these limits because of LIDCs, as well as what is known as the "public service doctrine."[8] This "doctrine" states that projects financed by IRBs must confer a "public benefit," such as the development of a new industry or a reduction in unemployment. A typical example is the Pennsylvania Industrial and Commercial Development Authority Law, which states that local industrial development authorities shall operate

> for the purposes of alleviating unemployment, maintaining employment at a high level . . . and developing business opportunities by the construction, improvement, rehabilitation, revitalization, and financing of industrial, commercial, manufacturing, research and development enterprises.[9]

These activities are said to "promote the health, safety, morals, and general welfare of the people."

The rationale for government intervention through IRB financing is therefore based on the classic notion of market failure. That is, it is alleged that if for some reason information about market opportunities, production technology, access to capital markets, etc., is not available to all producers, market forces will not allocate resources in an efficient way and the economy will produce below its capacity. The market failure argument has been used in defense of IRB finance of "small" businesses in particular, given the emphasis which has been placed on limiting industrial revenue bond use to "small issues."

Even though "market failure" is the principal rationale for public policy intervention, it is now widely acknowledged that the "inadequacy of market outcomes" is only a necessary, not a sufficient, condition for government intervention in the economy.[10] Public pol-

[7]Council of State Governments, *Economic Development in the States* (Chicago Council of State Governments, 1966), p. 1.

[8]Institute of International Law and Economic Development, p. 76.

[9]Ibid.

[10]See Charles Wolf, Jr., "A Theory of Nonmarket Failure: Framework for Implementation Analysis," *Journal of Law and Economics*, April 1979, pp. 107–139.

icy formulation requires that market failures be compared to the prospective failures of government to "correct" them. There are many examples of government intervention actually exacerbating problems caused by "market inadequacies," i.e., urban renewal and poverty programs, regulation of the airline and trucking industries, and so on. When political resource allocation replaces market allocation, the consequences are likely to be arbitrary and are often contrary to the interests of the general public. Consumer sovereignty, which induces producers to allocate resources to their most highly valued use, is replaced by "political sovereignty." And past experience provides no reason to expect politicians to be particularly concerned with allocative efficiency. Equity, however defined, is no more likely under political resource allocation than market allocation, and politics can create greater inequities than does the market.[11] How politicians allocate resources that are under their control will depend upon their perceptions of the personal benefits (votes, campaign contributions, etc.) that accrue from alternative allocations. As James Buchanan has observed:

> Politicians are politicians because they want to be. They are no more robots than other men. Yet the politician who would do nothing other than reflect the preferences of his constituents would, in fact, be robotlike in his behavior. Few, if any, politicians are so restricted. They seek office because they seek "profit," in the form of "political income," which will normally be obtained only if their behavior is not fully in accord with the desires of electoral majorities. Those men who are attracted to politics as a profession are likely to be precisely those who have considerable interest in promoting their own version of good government, along with those who see the opportunities for direct and indirect bribes, and those who evaluate political office as a means toward other ends.[12]

Thus, even if there are market imperfections which preclude "small" firms from competing, whether industrial development agencies can promote economic growth and reduce unemployment is uncertain. Such goals will only be pursued if it is in the interest of political decision makers to do so. In fact, it may be contrary to the interests

[11]A classic example is federal "urban renewal" programs which have demolished about twice as many housing units as they have replaced, and a large percentage of those replaced have been for middle- and upper-income individuals. Wealthier people are not only better off competing in the marketplace than less wealthy people, but are also more influential politically.

[12]James M. Buchanan, "Why Does Government Grow?" in Thomas E. Borcherding, ed., *Budgets and Bureaucrats: The Sources of Government Growth* (Durham, N.C.: Duke University Press, 1977), pp. 3–18.

of IDA managers to reduce unemployment and to increase economic growth. With low unemployment and steady growth, there is little need for an "agency" to "promote" low unemployment, just as without an "energy crisis" there is little need for a Department of Energy.

The Effects of Industrial Revenue Bond Finance

Can IDAs be expected to improve the allocation of resources caused by market imperfections and to aid the economy in producing at full capacity? At the outset, it is important to recognize that in one very important respect IDAs intensify rather than ameliorate market imperfections. Namely, when IDAs grant preferential treatment to failing businesses, as they often do, consumers are forced to pay (through taxes) for goods and services they would not otherwise prefer, and inefficient producers make use of resources that would otherwise be put to more highly valued uses in other industries. Both consumer sovereignty and production efficiency are reduced. Conferring preferential tax status on failing businesses, "large" or "small," constitutes nothing more than special interest legislation which distorts the structure of the market from that which would otherwise emerge.

Once IDAs are established and begin to prop up failing businesses, *there are stong incentives for their continued growth and expansion.* The reason for this is that the selected tax exemptions are provided to relatively small, concentrated groups, whereas the costs (in resources diverted from their highest-valued uses) are widely dispersed among the general public and well hidden. The selected group obviously has a strong incentive to promote the expanded use of IRB finance, while the average taxpayer has little incentive to oppose it, even though the *total* costs to society may far exceed the benefits to the firms.

Can IDAs be expected to aid "small" businesses which would otherwise be precluded from operating due to market imperfections? There is no doubt that many small businesses, failing or otherwise, receive IRB financing from local IDAs. It is also quite clear that there is a great deal of "political income" to be earned by offering IRB financing to large as well as small firms. In fact the record clearly shows that IRBs have been used to finance large manufacturing firms as well as auto dealerships, motels, doctors' and lawyers' offices, cable TV systems, banks, ski resorts, bowling alleys, country clubs, topless bars, and "adult" bookstores.[13] Thus, a large volume of IRBs

[13]Robert M. Bleiberg, "Corporate Food Stamps," *Barron's*, August 17, 1981, p. 7.

are used to finance the nation's largest corporations. Ironically, the subsequent advantages granted to larger corporations allow them to drive smaller retailers and merchants out of business in many cities.

The Congressional Budget Office recently completed a study of IRBs and found that about 16 percent of the total volume of small issue IRBs in 1978 and 1979 went to the top 50 companies on the Fortune 500 list. Table 2 lists selected Fortune 500 (industrial and nonindustrial) firms which received $1.2 billion in IRB financing in 1978 and 1979. Other Fortune 500 manufacturing firms received an additional $390 million. As shown in Table 2, large manufacturing and retailing firms have used IRBs to finance major investment projects. For example, K mart financed 96 stores in 19 states between 1975 and 1980, including 35 stores in 1980 alone. Similarly,

TABLE 2

SELECTED FORTUNE 500 FIRMS RECEIVING IRB FINANCING IN 1978–79

Firm	Amount of Bond Issue
Procter & Gamble Co.	$ 6,500,000
General Mills, Inc.	26,200,000
K mart Corp.	90,140,000
Exxon Corp.	24,000,000
Mobil Oil Corp.	63,000,000
Standard Oil Co. of Ohio	675,000,000
Phillips Petroleum	20,000,000
Atlantic Richfield Co.	61,055,000
Union Oil of California	22,500,000
Burlington Industries	9,500,000
Mead Corp.	7,800,000
Ford Motor Co.	23,345,000
McDonald's Corp.	17,400,000
Hoover Universal, Inc.	20,000,000
B. F. Goodrich Co.	3,000,000
Goodyear Tire & Rubber Co.	20,890,000
Weyerhaeuser Co.	18,000,000
Norton Co.	28,800,000
Dana Corp.	13,605,000
Union Camp Corp.	20,470,000
Georgia Pacific Corp.	9,500,000
Joy Manufacturing Co.	7,200,000

SOURCE: *Moody's Municipal and Government Manual* (New York: Dun and Bradstreet Co., 1981).

McDonald's financed 32 new restaurants in Pennsylvania and Ohio in 1979.[14] Other major companies making use of IRBs include Nabisco, PepsiCo, Allied Chemical, Container Corporation of America, and International Paper, to name only a few. Overall, more than half of the Fortune 500 firms received IRB financing during the 1978–79 period.

Thus, IRBs further distort the efficient (market) allocation of resources by providing "tax exemptions" to selected firms, large and small. Not applying laws regarding tax reduction equally to *all* firms and individuals is sure to disrupt the entrepreneurial process whereby scarce resources tend to be allocated to their most highly valued uses. Since market prices are altered by such arrangements, information regarding true benefits and costs is distorted, which makes it difficult, if not impossible, to discover the most highly valued resource use or least cost production techniques.

IRB finance of large corporate enterprises imposes further costs on society by establishing regional monopolies in various industries. One can readily think of how the construction of a K mart can drive small local retailers who have not benefitted from IRBs out of business. Established merchants and restauranteurs in many cities have protested IRB financing of their larger competitors but have had limited success in restraining their use. In July 1980, however, over 2,200 voters in Ravalli County, Montana, signed petitions calling for a referendum on the use of $4 million in IRBs to construct a K mart shopping center. Local merchants eventually succeeded in having the bond issue placed on the November election ballot. The bond issue was defeated.[15]

This particular type of "political warfare" amplifies yet another cost of government intervention by IDAs which tends to reduce the economy's productive capacity. Namely, the existence of a mechanism for distributing IRBs creates "economic rents" or above-normal profits. Consequently, resources will be used in obtaining, maintaining, extending, and (by some) eliminating these rents. The use of resources for purposes of "rent seeking" (and "rent avoidance") represents a deadweight loss to society since these resources are used in attempts to transfer wealth rather than to produce additional goods and services.[16] The establishment of industrial development agen-

[14]*Moody's Bond Record,* January 1981, pp. 109–22.

[15]Congressional Budget Office, p. 30.

[16]For a discussion of rent seeking see James Buchanan, Robert Tollison, and Gordon Tullock, eds., *Toward A Theory of the Rent-Seeking Society* (College Station, Tex.: Texas A&M Press, 1980).

cies will therefore reduce the economy's productive capacity, but provides a means by which local politicians can capture rewards (political profit) from handing out government empowerments. For example, in 1980 the village of South Barrington, Illinois, sold $18 million worth of IRBs to finance two Marshall Field department stores and a Carson, Pirie, Scott department store. For its efforts the local IDA managers collected "fees" of $100,000 from Marshall Field and $67,000 from Carson, Pirie, Scott.[17]

The lobbying costs of IRB beneficiaries are only a part of the total costs associated with rent seeking. Total rent-seeking costs would include those borne by firms which lobbied unsuccessfully for subsidies as well as those borne by investment bankers and law firms which also benefit from increased IRB sales, and by those businesses, i.e., smaller merchants, who oppose IRB financing. For example, the first vice-president of a major investment banking firm has boasted that "we've been responsible for changing the laws (regarding enabling legislation for IRB sales) in fifteen states."[18]

There are, of course, benefits to IRB finance inasmuch as IRBs provide a form of tax relief, albeit indirect. However, it is unlikely that the *net* benefits of IRB finance would be positive, given the costly economic distortions discussed above. Ideally, the free access of all firms to IRB finance would be more conducive to stimulating production and employment while limiting various economic distortions. Such an alternative would be analogous to across-the-board reductions in the taxation of corporate income, but is not likely to materialize.

Summary and Conclusions

In sum, industrial revenue bonds tend to distort, rather than facilitate, the market process. Both consumer sovereignty and production efficiency are compromised when IRBs are used to support failing or inefficient business enterprises. Further, the increasing use of IRB finance alters relative prices, which makes it more costly for consumers and producers to make accurate decisions regarding resource uses. The entrepreneurial process whereby resources are put to their most highly valued uses is disrupted. In essence, IRB finance substitutes political resource allocation for the market allocation of resources, and the results are neither efficient nor equitable. The economy's productive capacity is reduced when IRBs are used to

[17]*Chicago Tribune*, May 11, 1980.

[18]Walsh, p. 151.

selectively help some firms through special tax exemptions chosen by political rather than economic criteria, and when resources are used to obtain such exemptions rather than to produce additional goods and services.

While it is indeed desirable to reduce the burden of corporate taxation and regulation, there are surely more direct ways of doing so rather than the selective distribution of industrial revenue bonds.