



## TRENDS IN THE ISSUANCE OF CALIFORNIA CONDUIT BONDS ISSUED FOR ECONOMIC DEVELOPMENT PURPOSES

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*Editor's Note: CDIAC recently held a pre-conference at the annual California Bond Buyer Conference. The focus of the pre-conference—conduit bond financing—included a session on financing basics that covered, among other things, recent trends in conduit financing for economic development purposes. This article is an outgrowth of the research completed for that session.*

Section 141 of the Internal Revenue Code provides for the limited use of tax-exempt financing by private entities. This exception seeks to engender public-private partnerships that allow businesses to access low-cost financing and governments to harness private resources for public good. State and local entities, acting as a “conduit” for the purpose of financing the project, are authorized to issue private activity bonds and pass through the debt service obligation to a non-governmental issuer.

In California, tax-exempt private activity bond issuers must obtain an allocation of volume cap from the California Debt Limit Allocation Committee. The amount of the cap was increased in December 1999 nationwide and now stands at the greater of \$75 per state resident or \$225 million. Projects must meet specific criteria to qualify for an allocation. Financing for industrial development projects, for example, must be used for the purchase or improvement of depreciable assets and is limited to \$10 million for all capital expenditures within the issuer's jurisdiction. In addition to industrial development projects, private activity bonds may be used for airports, housing, pollution control equipment, solid waste recovery facilities, and power generation.

In support of a growing debate on how public funds may best be used to drive economic growth, the California Debt and Investment Advisory Commission (CDIAC) examined trends in the issuance of conduit debt used for economic development purposes over the past ten years. CDIAC defined economic development as debt used for transportation (airports, ports and marinas), utilities (power), solid waste facilities,

industrial and commercial development, and capital improvements. Other conduit debt, including education, housing, and health care was not included.

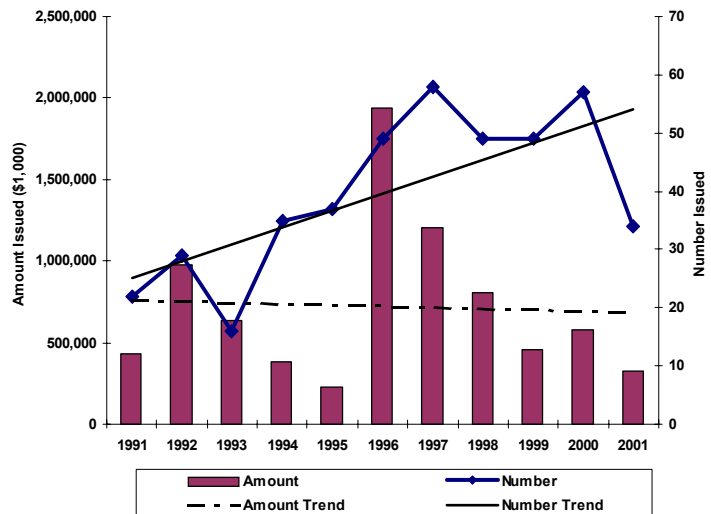
### Number and Volume of Issues

Between 1991 and 2001, public entities in California issued 435 “new money” conduit revenue bonds for economic development purposes. During the same period, these entities issued an additional 20 bonds for the purpose of refunding existing debt. Total issuance for new money bonds amounted to roughly \$8 billion, representing approximately 15 percent of all conduit debt issued between 1991 and 2001.

Chart 1 highlights the volume and number of economic development conduit bonds issued during the study period. It captures the volatility in both the number and volume of conduit bond issuance.

Chart 1

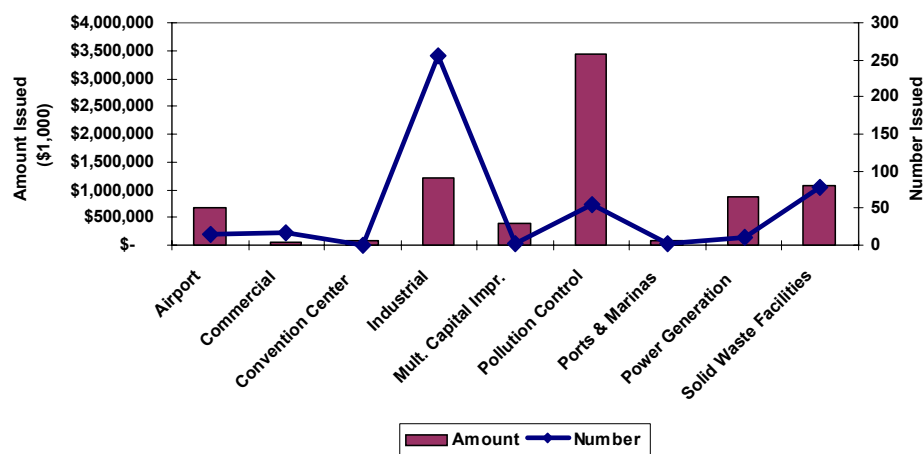
Conduit Revenue Bonds in California  
Economic Development Purposes  
1991 – 2001



The highest dollar value of issuance for these bonds in California was in 1996 when issuers sold \$1.9 billion through 49 different transactions. The greatest number of transactions occurred the following year, however, when issuers transacted 58 deals. The trend in dollar volume of issuance, while erratic, has declined over the period. In contrast, the trend in the number of bonds issued has steadily risen since 1991.

Chart 2 differentiates the use of economic development conduit financing by purpose. The highest volume of debt was issued to finance pollution control. Conduit issuers issued \$3.4 billion in debt for this purpose. The greatest numbers of transactions were carried out for the purpose of financing industrial activities. Conduit issuers transacted 255 industrial development bond transactions between 1991 and 2001.

Chart 2  
The Uses of Economic Development  
Conduit Financing  
1991 – 2001



### What Drives the Use of Economic Development Conduit Financing?

In foregoing tax revenues from interest income, the federal government expects that the use of private activity bonds will create greater public good than could be derived from programs funded with those foregone tax revenues. Several studies have been conducted to assess the economic and social outcomes of conduit financing with varying results and implications for their continued use.

To contribute to this discussion, CDIAC compared the pattern of conduit issuance in California to the underlying goals of economic development conduit financing, namely, providing a lower cost of financing to private entities that provide specific public benefits through their activities. Focusing specifically on industrial development bonds (IDBs) because the large number of issues provides for a more robust statistical analysis, CDIAC compared the volume of debt issued to the prime rate offered by banks in the U.S., the rate of inflation (CPI), and a measure of financial risk that might affect the willingness of private firms to use tax-exempt bond financing.

CDIAC expected that the prime rate and the rate of inflation would affect whether private firms used equity or debt for expansion. As the prime rate and the CPI rise, the likelihood of seeking tax-exempt financing should increase. The risk factor, calculated as the difference between the rate of a 10-year Treasury Note and a similar term AAA-rated corporate bond, also should be associated with industry's willingness to seek tax-exempt financing. The larger the difference between the low risk investment and the higher risk corporate bond, the more likely private companies will be to seek out the assistance of conduit issuers to access the tax-exempt market.

Using these indicators, CDIAC expected to see some correlation between the use of IDBs and the cost of capital or market risk associated with bond financing. CDIAC's analysis shows that a positive relationship between IDBs, the prime rate, and the CPI does appear to exist (Table 1 at the end of this article offers readers the Correlation Table utilized for this analysis).

The relationship between the risk factor and the issuance of IDBs, however, was negligible.

CDIAC also examined the role of IDBs in industrial development to determine if a relationship exists between low-cost financing and industrial productivity. In short, were IDBs being used at a time that businesses were expanding and the economy was growing or the reverse? Measures of industrial productivity used in this analysis were the Federal Reserve Bank's Industrial Production Index, the California Employment Development Department's data on the number of manufacturing jobs, the U.S. Department of Commerce's accounting of new capital expenditures by manufacturing firms in California, and their measure of U.S. investment in manufacturing assets.

A correlation analysis revealed that IDB issuance was strongly related to capital investment in California manufacturing firms and less strongly to U.S. investment in manufacturing assets. The issuance of IDBs was weakly related to U.S. industrial output and not related to the number of California manufacturing jobs. Thus, the analysis suggests a greater use of IDBs during expansionary periods for businesses (when capital investment in manufacturing firms is growing) rather than the reverse.

The fact that the issuance of IDBs is linked to the growth of California manufacturing firms explains, at least in part, the decline in the use of this economic development conduit financing tool during the past 18 months. In the current recessionary environment, firms appear to be unwilling to launch new projects even though the cost of capital is extremely

low. This fact raises an important policy question for government. Can IDBs be used to stimulate economic development or are they primarily a tool for assisting industry during expansionary periods? Ideally, a program that succeeds in meeting both conditions would provide the greatest use of IDBs for economic development financing purposes. As the California economy remains stagnant, additional public or public/private support may be needed to launch new investment. Once the economy begins to improve, existing public financing tools provide an alternative that helps to hold down the cost of capital and extends access to the capital markets to small borrowers.

Table 1

**Correlation Table\***

	<i>IDBs</i>	<i>Risk Factor</i>	<i>Prime Rate</i>	<i>CPI</i>	<i>Industrial Prod. Index</i>	<i>CA Manuf. Jobs</i>	<i>CA Capital Investment</i>	<i>U.S. Manuf. Investments</i>
IDBs	1							
Risk Factor	-0.0978	1.0000						
Prime Rate	0.4055	-0.1335	1.0000					
CPI	0.1103	0.5882	0.1798	1.0000				
Industrial Prod. Index	0.2427	0.5196	0.3666	0.9607	1.0000			
CA Manuf. Jobs	0.0439	0.4891	0.4353	0.4153	0.5464	1.0000		
CA Capital Investment	0.7890	-0.0523	0.7368	0.3086	0.5179	0.3169	1.0000	
U.S. Manuf. Investments	0.5673	-0.0918	0.8514	0.0033	0.2529	0.4802	0.8628	1

\*The correlation analysis reported here would need to be subjected to further statistical testing to provide a confidence interval measurement for these results. Additional tests would help control for certain factors such as the decline in total corporate debt and to reduce the effect of outliers such as large, atypical issues.

*This Offprint was previously published in DEBT LINE, a monthly publication of the California Debt and Investment Advisory Commission (CDIAC). CDIAC was created in 1981 to provide information, education, and technical assistance on public debt and investment to state and local public officials and public finance officers. DEBT LINE serves as a vehicle to reach CDIAC's constituents, providing news and information pertaining to the California municipal finance market. In addition to topical articles, DEBT LINE contains a listing of the proposed and final sales of public debt provided to CDIAC pursuant to Section 8855(g) of the California Government Code. Questions concerning the Commission should be directed to CDIAC at (916) 653-3269 or, by e-mail, at cdiac@treasurer.ca.gov. For a full listing of CDIAC publications, please visit our website at <http://www.treasurer.ca.gov/cdiac>.*

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