Tax–exempt Bonds, Professional Sports Stadiums, and Economic Policy

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The most important characteristic of tax-exempt bonds is their exemption from federal income taxation which lowers the interest rate below the rate on taxable bonds of equivalent risk and maturity. In effect, federal taxpayers pay a share of the interest costs through lower tax collections. That lower interest rate makes the bonds attractive to the private sector, which expends considerable effort to induce public officials to borrow and use the bond proceeds to finance private investments. Owners of professional sports teams are important participants in those efforts.

Since 1968, three different sets of tax rules have governed the use of tax-exempt bonds for financing professional sports stadiums. Those rules provide differing incentives and economic effects. I provide a brief history of the bond rules and discuss how those rules might be changed to achieve two commonly stated policy objectives: the elimination of federal financial support for professional sports stadiums; and the encouragement of local government stadium financing packages structured to implement the benefit principle of taxation so that those who benefit pay the cost.

Bond Rules and Stadium Finance over Time

1968 to 1986. Professional sports stadiums could be financed with tax-exempt bonds in two ways. Governmental debt had to satisfy one of two criteria: no more than 25 percent of the bond proceeds could be used by a nongovernmental entity; no more than 25 percent of debt service payments could arise from private business activity. In general, most of the financing costs of a stadium financed with governmental bonds rested with local taxpayers because at least 75 percent of the principal and interest on the bonds

would be paid from general tax revenue, not stadium-related cash flow. Those receiving most of the benefits from the stadium (owners, players, fans, and some related businesses) did not pay a proportionate share of the cost.

Bond issues that violated both 25 percent rules were industrial development bonds and were taxable. However, stadiums were among the list of activities exempt from the 25 percent rules. In general, most of the financing costs of a stadium financed with industrial development bonds rested with those receiving benefits from the stadium because most of the debt service would be paid from such sources as ticket taxes at the stadium (payments that arise from private business activity and, absent the exemption, would count against the 25 percent rule that would make the bonds taxable). In effect, the cash flow from the stadium was used to pay principal and interest on the bonds.

1986 to 2005. The Tax Reform Act of 1986 made significant changes. The 25 percent rules were reduced to 10 percent, and the name industrial development bonds was changed to private-activity bonds, terminology that better reflected the diverse list of activities eligible to use tax-exempt financing. However, stadiums were removed from the list of activities eligible to use tax-exempt private-activity bonds. The expectation was that local governments would be reluctant to use the other option, governmental debt, to finance stadiums, and the use of tax-exempt debt for financing stadiums would wither.

Two forces operated to frustrate that expectation. First, those who benefit most from stadiums (owners of teams, players, fans, some related businesses) learned how to utilize pseudo-economic studies to argue that the economic benefits from stadiums generated sufficient additional tax revenue to pay for the public subsidy, a proposition that runs counter to an extensive economics literature ably summarized at this hearing by Mr. Humphreys and Mr. Sanders. Second, the monopolistic structure of professional sports leagues maintains excess demand for franchises, forcing cities to compete for a limited number of franchises with offerings of stadium subsidies. As a result, many stadiums were built for which local taxpayers, who receive limited benefits, paid at least 90 percent of the debt service on the bonds.

2006. Stadium proponents have continually sought creative ways to reduce the requirement that local taxpayers must pay for 90 percent or more of tax-exempt debt service. In 2006, the Internal Revenue Service approved one of those creative efforts when it issued a letter ruling for the financing of New York City stadiums that said, in effect, stadium-related revenue could be used to pay the debt service on governmental debt. Since 1986, payment of more than 10 percent of debt service with stadium-related revenue would make the bonds taxable private-activity bonds. But IRS ruled that stadium-related revenue is actually payments in lieu of taxes (PILOTs) and qualifies as generally applicable taxes, not as revenue arising from private business activity. Suddenly, private-activity bonds, as they have been understood since 1986, can be used to finance stadiums because the 10 percent debt service rule has been eviscerated and private-activity bonds are now governmental bonds.

Policy Discussion

Whether the IRS ruling and the current state of tax-exempt stadium financing is desirable or undesirable depends upon whether one's goal is to eliminate federal subsidy of professional sports stadiums or to promote economic efficiency by making stadium financing more closely approximate the benefit principle of taxation.

PILOTs as poor policy. If one's goal is to eliminate federal subsidy of stadiums, the PILOT ruling is undesirable. It reduces the burden on local taxpayers because cash flow from the stadium substitutes for general taxes in the financing of debt service and reduces the need to raise general taxes. That is likely to reduce local taxpayer resistance to public financing of stadiums. Even worse, renaming business-related revenue as PILOTs might open the door for widespread tax-exempt governmental bond financing of private investment projects not currently on the list of activities exempt from the private-activity bond 10 percent rules. It raises the prospect of making elected officials into commercial bankers in charge of allocating ever-larger portions of the nation's scarce supply of savings, a role that the 1986 tax act was designed to curb.

A straightforward way to eliminate federal subsidy of professional sports stadiums would be to add a prohibition against the use of tax-exempt governmental bonds for stadiums to the existing prohibition against use of private-activity bonds. Former Senator Daniel Moynihan championed that approach when he introduced STADIA (Stop Tax-exempt Arena Debt Issuance Act) in 1996. Prohibition could be implemented by eliminating the

10 percent security interest test for stadiums; a professional sports stadium would always fail the 10 percent private use test and be classified as a taxable private-activity bond.

Such outright prohibition of state and local use of tax-exempt financing for governmental debt is rare. I can think only of two instances: a prohibition against its use to finance public takeover of investor owned utilities; and a prohibition against its use to finance the acquisition of rental properties outside the boundaries of the jurisdiction issuing the bonds. But if one's object is to eliminate the federal subsidy of professional sports stadiums, outright prohibition is clearly the most effective tool.

Outright prohibition is consistent with the view that federal taxpayers receive no economic benefit. Even if a stadium generated positive economic benefits for a local government, which testimony given here suggests is not the case; the benefits for federal taxpayers are zero. The fiscal impact of the federal budget, such as creating jobs, is determined when the budget resolution is passed. How the money is divided up is irrelevant; all activities on which it can be spent create jobs. The only exceptions are those federal activities that are specifically directed toward altering the structural elements of the economy that affect the natural rate of unemployment, such as job training, better information about job availability, or net increases in human capital and research. Tax-exempt bonds do not accomplish that objective.

PILOTS as good policy. If one's objective is to implement the benefit principle of taxation that would require those who receive benefits from the stadium to pay its costs,

the PILOT ruling might be beneficial. Some argue that society overinvests in stadiums because the dominant political coalition that pushes for stadiums receives most of the benefit while others in society pay most of the cost. The IRS PILOT ruling promotes the benefit principle. In effect, it would allow stadium-related revenue to be used to pay debt service and would reduce the pressure to finance stadiums with general tax revenue. Stadium-related revenue is generally paid by those receiving direct benefits from the stadium, whereas generally applicable taxes such as income, property, and sales taxes are poorly related to stadium usage and the receipt of benefits. It would be efficient because it would bring the dominant political coalition's benefits and costs into better balance, thereby rationalizing prices.

However, one must balance that improvement in economic efficiency against the danger that the PILOT precedent will lead to its general application across the spectrum of private business activity, as discussed in the previous section.

An Alternative Policy. A three-step compromise is available that could advance both policy objectives: add stadiums to the list of private activities eligible for tax-exempt financing; subject stadium bonds to the private-activity bond volume cap; and wipe the PILOT precedent off the books. Private-activity bond financing would encourage use of the benefit principle of taxation. Requiring stadium projects to compete for scarce private-activity bond volume cap with other eligible private activities such as mortgage revenue bonds, small-issue industrial development bonds, and student loan bonds would minimize the federal subsidy. And eliminating the PILOT precedent would prevent its

indiscriminate application to a broad range of private activities and would control elected officials' role of commercial bankers.