United States General Accounting Office

GAO

Briefing Report to the Honorable
Fortney H. (Pete) Stark
House of Representatives

July 1986

TAX POLICY

Use of Tax-Exempt Bonds in Oakland, California

036222

GAO

United States
General Accounting Office
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General Government Division

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July 24, 1986

The Honorable Fortney H. (Pete) Stark
House of Representatives

Dear Mr. Stark:

In your January 9, 1986, letter you asked us to obtain information on the use of tax-exempt bonds by Oakland, California, for various purposes, including transactions to sell and leaseback city assets. You also asked that we pay close attention to recent allegations that Oakland planned to use bond proceeds to give the Oakland Athletics baseball team a loan.

The data we gathered show that between January 1, 1983, and May 31, 1986, Oakland sold 18 tax-exempt bond issues totalling $589 million. We estimate that over their life these bonds, in present value terms, will cost the U.S. Treasury $91 million and the state of California $19 million in foregone income tax revenues. While we did not quantify bond benefits, we did visit selected facilities, some completed and some under construction, that were financed by bond proceeds. These facilities, and other benefits which Oakland officials attribute to the bonds, are described in this report.

In reviewing the loan transaction Oakland is considering for the baseball team, we found the tax law to be unclear. The key issue is how far the statute goes in defining the concept of indirect financing. Generally, the law prohibits the use of bond proceeds for private purpose loans. In the instance of the proposed loan, however, it is difficult to determine the source of funds that will be loaned due to the series of accounting entries that Oakland proposes. Given this, the Congress may want to clarify its intent on the use of tax-exempt financing to support private purpose loans.

We obtained our information primarily from city officials and city records. We also discussed current provisions of the tax code with attorneys at the Internal Revenue Service (IRS) and followed a methodology which is used by the Treasury to estimate the federal government's foregone income tax revenue.

As directed by your office, we did not obtain official comments on a draft of this report. We did, however, discuss our report with the Oakland City Manager, who agreed with the facts presented. We also discussed sections of this report with IRS attorneys, who agreed that we had accurately presented their unofficial views.

As arranged with your office, we are sending copies of this report to Oakland city officials and organizations which furnished us with data. We also are sending copies to the Secretary of the Treasury, the Acting

Commissioner of IRS, and congressional committees which oversee the tax area. Copies will be made available to others who request them. If you or your staff have questions regarding the information, please contact Mr. Johnny Finch at 275-6407.

Sincerely yours,

W. J. Anderson

William J. Anderson
Director

Contents

ABBREVIATIONS

ACRS	Accelerated Cost Recovery System
A's	Oakland Athletics baseball team
GAO	General Accounting Office
IRS	Internal Revenue Service
YMCA	Young Men's Christian Association

SECTION 1

THE MUNICIPAL BOND MARKET

AND OAKLAND'S USE OF THIS MARKET

State and local governments, faced with federal cutbacks and taxing constraints, have devised a number of innovative ways to fund public goods and services. One way, which is attractive both to investors and these governments, has been to expand the use of tax-exempt financing instruments. States and localities find these instruments attractive because they can borrow money at lower interest rates than on taxable financial instruments, and investors find these attractive because the interest income they receive--although lower than what they might obtain elsewhere--is exempt from taxation.[1] Between 1980 and 1985, volume in the municipal bond market[2] increased 218 percent, from $76 billion to $242 billion.[3] While these instruments benefit state and local governments and investors, the federal government foregoes tax revenue because the interest paid on these bonds is exempt from the federal income tax.

The municipal bond market covers numerous types of tax-exempt financing instruments,[4] including (1) bonds, (2) certificates of participation, and (3) notes. Bonds are used to finance various types of endeavors, such as roads, sewers, industrial development, and low-income housing, including both multifamily rental housing and single-family mortgages. Certificates of participation--which are used in some states--are like bonds and are issued in conjunction with a lease or purchase of property by the municipality. They entitle the certificate holders to a share in the lease or installment payments. Notes are short-term

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[1]Since the enactment of the United States income tax in 1913, the interest paid on obligations issued by state and local governments has generally been deemed to be free from federal income taxation.

[2]The municipal bond market includes obligations, whether for public or private purposes, issued by states, counties, cities, school districts, and other jurisdictions such as water and sewer authorities.

[3]Source: Public Securities Association. These figures include both long-term and short-term debt. Long-term debt totaled $49 billion in 1980 and $219 billion in 1985.

[4]We use the terms tax-exempt financing instruments, tax-exempt transactions, and tax-exempt bond issues interchangeably throughout the report.

debts customarily used to smooth out cash flows when expenditures exceed revenues.

Tax-exempt financing instruments are secured as either "general obligation" debt or "limited liability" debt. To issue general obligation debt, the government entity promises unconditionally to pay the interest and principal, based on its power to levy taxes.[5] In contrast, the issuer pays limited liability debt from specific revenues such as rents, user fees, or special taxes. Should these revenues prove inadequate, the issuer is not responsible for repayment. In issuing limited liability debt (for example, industrial development bonds) the government entity may function as a conduit; that is, it borrows funds from investors and lends them to a developer to build a privately owned project, such as a parking garage. Revenues from the project are used to pay off the debt's principal and interest.

Until the late 1970s, tax-exempt bonds were predominantly used to finance traditional governmental initiatives, such as constructing educational facilities and public infrastructure including roads and bridges. In recent years, however, tax-exempt bonds have increasingly been used for nontraditional or "nongovernmental" purposes, such as industrial development, private hospitals, and housing.

Before 1968 the Congress encouraged broad use of tax-exempt financing by exempting interest on all state and local government bonds from federal income taxes--regardless of how the state or locality used the bond proceeds.[6] In 1968, it narrowed this concept in deciding that the interest on revenue bonds would be taxable unless issued for specific purposes such as constructing sewage facilities. In 1969, 1980, 1982, and 1984 the Congress further restricted the use of tax-exempt bonds through a series of actions.

--In 1969 it restricted "arbitrage"--i.e., the income that a municipality could earn by reinvesting tax-exempt proceeds in higher yielding assets. If reinvestment earnings exceed a specified limit, the original bonds become taxable.

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[5]According to California Debt Advisory Commission statistics, few general obligation long-term debt instruments have been issued in California since 1982. In fact, few of these types of instruments have been issued since 1978 when "proposition 13" limited the ability of local governments to increase property tax rates.

[6]Section 103 of the Internal Revenue Code governs the tax exemption of state and local government debt.

--In 1980 it required that tax-exempt bonds for single family mortgages and multifamily rental housing be used, at least in part, to help low- and moderate-income individuals.

--In 1982 it (1) prohibited the use of the accelerated cost recovery system (ACRS) in favor of a less generous type of depreciation when financing the purchase or lease of property, (2) required that an elected official approve the bond issue after a public hearing or that voters approve it by referendum, and (3) tied the maturity of bonds to the economic life of the property financed.

--In 1984 it limited the volume of nongovernmental bonds that a municipality could issue by imposing an annual per capita cap and enacted additional arbitrage restrictions.

In December 1985 the House of Representatives passed a tax reform bill (H.R. 3838) that would further restrict the tax-exempt market. The bill would adopt a more restrictive definition of a governmental municipal bond and it would expand the types of bonds subject to per state volume limitations. The bill would also establish a single volume limitation that would apply to all nongovernmental bonds (except certain airport facilities) and a portion of some governmental bond issues.[7]

The Senate version of H.R. 3838, on the other hand, would retain present law for most provisions affecting tax-exempt financing. According to the Senate Committee on Finance's report on H.R. 3838, one reason why the Senate chose generally to retain present law was that state and local governments were already experiencing severe constraints on their ability to provide public services. One constraint has been the decline in direct federal spending and the corresponding increase in state and local responsibilities in those areas where the federal government has reduced its involvement (for example, housing and education). Another reason why the Senate chose to retain most of the present law was that its bill, unlike the House bill, would not allow individual taxpayers to deduct state and local sales taxes. Both bills would thus reduce the tax subsidy to the state-local government sector by the federal government, but they would achieve that objective differently.

Within this context of tax reform debate, Congressman Stark asked us to undertake a case study of Oakland's use of tax-exempt financing.

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[7]For a more detailed discussion of the proposed restrictions, see Aaron S. Gurwitz, "HR-3838 and the Municipal Bond Market: Proposed Changes and Potential Impacts," Salomon Brothers, Inc., January 1986.

OAKLAND HAS ISSUED 18 TAX-EXEMPT INSTRUMENTS SINCE 1983

Between January 1, 1983, and May 31, 1986, the city of Oakland and the Oakland Redevelopment Agency[8] issued 18 tax-exempt instruments (3 short-term and 15 long-term) totaling about $589 million.[9] (See table 1.1.) The long-term debts are limited obligations; that is, none is backed by the full taxing power of the city. The short-term notes are general obligation debt secured by anticipated tax revenues. As of May 31, 1986, 16 of the 18 instruments--1 short-term and 15 long-term--worth $533 million were outstanding. (See apps. I and II for comparative information on these transactions and apps. III to VIII for descriptions of each type of transaction.)

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[8]The city council created the Oakland Redevelopment Agency and sits as its governing body. We make no distinction between the Agency and the city except when the two bodies are involved in the same transaction, such as the sale and leaseback of the convention center.

[9]In June 1986, the city refunded two long-term tax allocation bond issues--the $50 million issue included in our review and a $33 million one issued in 1979. Our statistics do not reflect this refunding.

Table 1.1: Summary of Oakland's Tax-Exempt Issues

Number of Issues	Type of Issue	Purpose of Issue	Amount of Issue(s) (millions)
3	Short-term tax and revenue anticipation notes	To even out cash flows between expenditures and receipts.	$ 91.5
7	Long-term, small issue industrial development bonds	To help private parties and a government agency develop, build, or purchase commercial establishments or other facilities.	$ 46.6
1	Long-term mortgage subsidy bond	To purchase mortgages, in part for low- and middle-income families.	$ 23.2
2	Long-term multifamily rental housing bonds	To build rental housing, in part for low- and moderate-income families and the elderly.	$ 61.0
1	Long-term, special-assessment district bond	To build a parking garage within a hospital and medical complex.	$ 4.8
1	Long-term, tax allocation bond	To build and develop commercial and retail establishments in a redevelopment area.	$ 50.0
1	Long-term certificate of participation	To enable the Redevelopment Agency to purchase 23 properties from the city. The city used the sale proceeds to finance a pension liability.	$221.5

1	Long-term certificate of participation	To enable the Redevelopment Agency to purchase the convention center. The city uses the sale proceeds to fund capital improvements.	$ 38.0
1	Long-term certificate of participation	To finance the construction of capital improvements.	$ 52.3

We did not attempt to determine if Oakland would be able to pay off its tax-exempt issues on time. However, officials at California Municipal Statistics, Inc., a nonprofit corporation which compiles data on the outstanding bonded debt of California local governments, are performing a study of Oakland's financial position which they expect to complete sometime this summer. In May 1986 these officials said that Oakland is in a more "exposed" financial position than other California cities of comparable size. They explained that the city's bonded debt service to general fund ratio was substantially higher than the other cities. One reason the debt ratio was higher, according to these officials, is that these other cities have not funded pensions through bonded debt, though the localities may have unfunded pension liabilities.

OAKLAND'S SOURCES OF REVENUES

Oakland's sources of revenues have changed over the last 5 years. Federal and state funding has declined, and local property tax rates are limited by the California constitution.[10] The city has come to rely on other funding means to provide services to its citizens and to develop the community. Figure 1.1 compares the city's revenue by source for the fiscal years 1981 and 1985.

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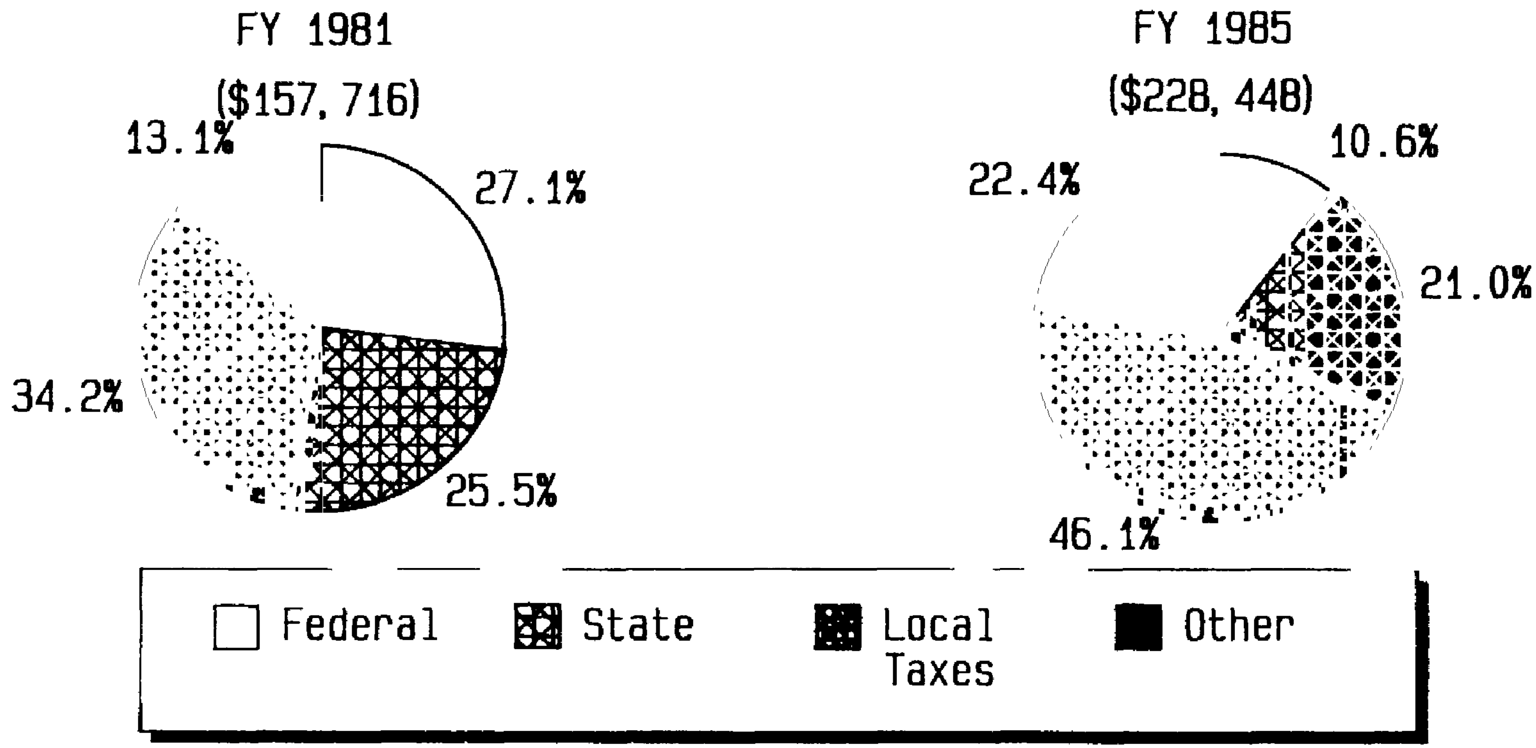
[10]On June 3, 1986, California voters amended the constitution to allow local voters the right to increase the property tax rate to back general obligation bonds for specific purposes, if two-thirds of the local voters approve the increase.

Figure 1-1:
Oakland's Revenues by Source
(Thousands)



Notes: Proceeds from sale of tax-exempt issues are considered loans, not revenue, and are not included. "Other" includes property sales, investment and interest income, fines, and penalties.

Percentages do not add to 100 due to rounding.

OBJECTIVES, SCOPE, AND METHODOLOGY

Congressman Fortney Stark, in a January 9, 1986, letter, requested that we do "a case study of Oakland and its use of Federal tax provisions to fund . . . operations and capital projects." Specifically, Congressman Stark asked that we determine what tax-exempt transactions occurred after 1982, including (1) how much interest was due on these issues, (2) how much was paid in commissions and fees, such as sales commissions and legal fees, (3) how much tax revenue was foregone by the federal government, and (4) how the proceeds were used. He subsequently asked us to expand these objectives to include a determination of how much tax revenue California lost and the benefits or advantages of these issues. Congressman Stark also asked that we pay close attention to recent allegations that Oakland planned to use bond proceeds to give the Oakland Athletics (A's) a loan.

We reviewed all tax-exempt financing transactions--bonds, certificates, and notes--entered into by the city of Oakland and the Oakland Redevelopment Agency between January 1, 1983, and May 31, 1986.[11] We did not attempt to determine (1) the legality of the transactions or (2) whether the city will be able to pay these debts on time.

We reviewed (1) the closing documents for each instrument, including the purchase agreement, trust agreement, and bond counsel opinion; (2) the city's accounting records related to each instrument; (3) other city records and reports which concerned these instruments; and (4) the city's and the Redevelopment Agency's audited financial statements for fiscal years 1981, 1982, 1983, 1984, and 1985, and the accompanying management letters. We did not audit the city's accounting records but we did test selected entries. However, we did not take a statistically valid sample and therefore cannot attest to the overall reliability of these accounting records. We did not review the records of the developers or financing intermediaries, except for those records contained in city files.

In addition to reviewing city records, we judgmentally selected and visited facilities, some completed and some under construction, that were financed by bond proceeds. We interviewed Oakland officials knowledgeable about each security. We also interviewed officials at the Government Finance Officers Association to obtain background information on municipal bonds, and we obtained data from California Municipal Statistics, Inc. We interviewed several Internal Revenue Service (IRS) officials

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[11]We did not review the tax-exempt issues of overlapping jurisdictions, such as the Port of Oakland, the Oakland Unified School District, or the county of Alameda.

to obtain data on how IRS treats various types of bonds. To understand the framework of Oakland's transactions, we also reviewed the Internal Revenue Code, Department of the Treasury regulations, and IRS revenue rulings that concern tax-exempt municipal bonds, certificates, and notes.

Appendix IX details the methodology we used to estimate the U.S. revenue losses. The approach we used is similar to that used by the Treasury in developing its revenue estimates of federal tax losses from tax-exempt securities. To estimate the revenue loss to California from the issuance of tax-exempt bonds by Oakland we used assumptions supplied by the state as to the amount of each bond issue held by California households and the borrowing cost of the state. Because some of these bonds do not mature for up to 30 years, we calculated both interest expense and tax loss for each year of the life of the bonds and then discounted them to obtain the present value of these elements. (See app. IX.)

We conducted our review between February and June 1986 in accordance with generally accepted government auditing standards.

SECTION 2

COSTS OF OAKLAND'S

TAX-EXEMPT FINANCING

Oakland's 18 tax-exempt issues result in both costs and benefits to various groups. Costs are borne by the federal government, the state of California, and the city government,[1] while the beneficiaries, who will be discussed in the next section, include developers, financing intermediaries, the community, and the city government. We estimated the gross federal taxes foregone to be $110 million, net federal taxes foregone to be $91 million, and state taxes foregone to be $19 million (all in present value terms). (See app. IX for the methodology we used.) We also estimated the city's interest payments on these securities to be $264 million (in present value terms), and commissions and fees over the life of the bonds to be $21 million.[2] (See app. I for the costs of each issue.)

These costs might be offset by (1) increased income tax revenues from commercial activities built with the debt proceeds[3] and (2) increased property tax revenues due to commercial development. However, our work provided no basis for estimating such offsetting revenues to the city, state, and federal governments.

On nine of the bond financed projects, developers or other users of the proceeds, instead of the city, are responsible for paying commissions and fees and the interest. We did not quantify the commissions and fees that will be so paid because the data were not available in city files. However, we did

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[1]These costs also include those for the Redevelopment Agency.

[2]Though the city is responsible for paying the special-assessment district bond fees, commissions, principal, and interest, most of these costs are paid out of the special-assessment property tax paid by the district. The single-family mortgage bond works in a similar manner. (See app. VI and V.)

[3]Federal income tax revenue would only increase to the extent that these commercial activities were expanded or truly new. If they were simply relocated activities with no expansion, then income tax revenue would not increase.

quantify the interest payments. These will total an estimated $61 million (in present value terms).

FEDERAL AND STATE TAX REVENUE FOREGONE

Tax-exempt financing results in foregone federal tax revenue, primarily because holders of such securities--bonds, notes, and certificates--pay no federal income taxes on the interest earned. At the same time, gross tax loss is offset to the extent that beneficiaries'[4] costs are lower. Table 2.1 presents both gross and net estimates, showing that the federal government will forego net tax revenue of about $91 million (in present value terms) on securities that Oakland issued between January 1, 1983, and May 31, 1986.

[4]For example, business borrowers will have higher taxable profits if tax-exempt bonds reduce their deductible interest expense.

Table 2.1
Oakland's Tax-Exempt Transactions Interest Payments and Tax Revenues Foregone
By Type of Issue
(January 1, 1983 - May 31, 1986)

(Percents are percent of grand total)

Type of Issue	Number of Issues	Amount of Issues	Present Value of Estimated Interest Payments Over Life of Issues	Present Value of Gross Federal Revenues Foregone -	Present Value of Adjustments to Federal Revenues Foregone (a) =	Present Value of Net Federal Revenues Foregone	Present Value of California Revenues Foregone
TAX AND REVENUE ANTICIPATION NOTES	3 16.67%	$91,500,000 15.54%	$5,361,253 1.65%	$2,928,089 2.66%	(b)	$2,928,089 3.22%	$220,751 1.17%
Subtotal short-term debt	3 16.67%	$91,500,000 15.54%	$5,361,253 1.65%	$2,928,089 2.66%		$2,928,089 3.22%	$220,751 1.17%
HOUSING BONDS	3 16.67%	84,175,000 14.29%	43,757,254 13.48%	23,438,265 21.29%	11,719,132 61.16%	$11,719,133 12.89%	2,528,714 13.38%
SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS	7 38.89%	46,600,000 7.91%	25,002,865 7.70%	14,885,704 13.52%	7,442,852 38.84%	$7,442,852 8.19%	1,383,477 7.32%
CERTIFICATES OF PARTICIPATION	3 16.67%	311,840,000 52.95%	208,353,573 64.20%	61,940,069 56.26%	(b)	$61,940,069 68.12%	12,082,708 63.95%
OTHER BONDS	2 11.11%	54,800,000 9.31%	42,064,076 12.96%	6,902,590 6.27%	(b)	$6,902,590 7.59%	2,684,747 14.20%
Subtotal long-term debt	15 83.33%	$497,415,000 84.46%	$319,177,768 98.35%	$107,166,628 97.34%	$19,161,984 100.00%	$88,004,644 96.78%	$18,679,646 98.83%
GRAND TOTAL	18 100.00%	$588,915,000 100.00%	$324,539,021 100.00%	$110,094,717 100.00%	$19,161,984 100.00%	$90,932,733 100.00%	$18,900,397 100.00%

Footnotes
(a) See app. IX for a discussion of how the adjustments were estimated.

(b) Adjustments were not estimated for public purpose bonds. See app. IX for an explanation.

We estimated California foregoes individual income tax revenue of $19 million (in present value terms) as a result of these transactions. The city does not forego income tax revenue because of these issues, for it levies no income tax.

Our federal and state income tax loss estimate is based on an economic model that assumes that investors would have purchased comparable taxable securities if these tax-exempt securities had not been available. (See app. IX for further details on our methodology.)

COSTS TO THE CITY GOVERNMENT

For 9 of the 18 issues, the city is responsible for paying fees and commissions to the intermediaries and interest to the investors. The costs for the other issues are the responsibility of the developer or whoever uses the bond proceeds.

The nine issues for which the city assumes all costs are the three short-term anticipation notes, the tax allocation bond, the three certificates of participation, the single-family mortgage bond, and the special-assessment district bond. Total estimated commissions and fees over the life of these nine issues will cost Oakland $21 million, including $674,000 for bond counsel. The estimated interest costs on these nine issues will be $264 million (in present value terms). The city is also responsible for paying back the principal ($481 million)[5] on this limited liability debt.

Oakland also incurs costs for staff time to develop and administer or monitor all the securities. We were unable to quantify these costs, because Oakland does not track staff time spent on a given security.

COSTS TO THE DEVELOPERS AND OTHERS

The nine issues for which the developers or other users of the bond proceeds are responsible for paying commissions and fees include the seven small-issue industrial development bond issues and the two rental-housing bond issues. Information needed to determine the total commissions and fees paid to the financing intermediaries for the sale and administration of these issues was not available.

In addition to these intermediary commissions and fees, the users are responsible for paying issuance fees and annual administration fees to the city. We estimate Oakland will

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[5]In fact, the city has repaid the principal on two of the short-term notes, leaving an outstanding principal balance of $426 million as of May 31, 1986.

receive fees over the life of eight of the nine issues totalling $2.0 million.[6]

The revenues from the developments are supposed to cover the costs for interest (as well as the principal) of the bonds. In addition the city has required that these users of the bond proceeds have some type of insurance for paying interest and principal if the user defaults. We estimated total interest on these nine issues at $61 million (in present value terms).

[6]The bond issued for the regional planning agency did not include city fees. However, the city received the same type of fees for two other bonds--the single-family mortgage bond and the special-assessment district bond. These fees total an estimated $97,000.

SECTION 3

BENEFICIARIES OF OAKLAND'S

TAX-EXEMPT FINANCING

The principal beneficiaries of Oakland's tax-exempt financing are developers, financing intermediaries, the community, and the city government. Developers benefit from the tax exemption through lower project-financing costs. Financing intermediaries who structure and market the securities benefit through fees charged the developer or the city. The community, according to city officials, benefits from these issues insofar as (1) "urban blight" is reduced in the downtown Oakland area, (2) commercial activity is spurred, (3) housing stock is increased, (4) employment in the construction trades is increased, (5) homes become more affordable for low- and middle-income families, and (6) a nonprofit organization and a regional planning agency get new facilities. The city government benefits, according to city officials, insofar as these issues (1) allow the city to pay its bills in a timely manner, (2) increase the tax base and future tax revenues, and (3) reduce the city's unfunded police and fire fighter pension liability. Underlying these officials' descriptions of the benefits accruing to the city and the community is their assumption that the funds provided through these 18 tax-exempt transactions would otherwise not have been available.

BENEFITS TO DEVELOPERS

Developers benefit from the lower interest costs of the tax-exempt issues, which may enable them to earn a greater rate of return than would be available from alternative investments, such as conventionally financed construction or rehabilitation loans. This lower interest rate reduces the developers' costs to build these commercial or multifamily housing projects--increasing the likelihood that they will find this type of investment more profitable (after tax considerations and adjusting for risk) than others.

We could not readily obtain data necessary to compare the profitability of alternative investments for Oakland developers. However, a previous GAO study noted that one developer said he saved about 23 percent of the project's gross annual revenue by using tax-exempt financing instead of conventional financing.[1]

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[1] Rental Housing: Costs and Benefits of Financing With Tax-Exempt Bonds (GAO/RCED-86-2, Feb. 1986).

BENEFITS TO FINANCING INTERMEDIARIES

Financing intermediaries--such as underwriters, trustees, and bond counsel--benefit from tax-exempt securities to the extent that this financing method creates additional demand for their services. While conventional financing also carries associated fees, certain fees collected by these parties are unique to bond financing. For example, a trustee is not usually used in conventional financing arrangements. We do not know how much additional income these intermediaries received because of Oakland's tax-exempt issues. For one thing, we do not know the amount of fees associated with conventional financing. However, we did determine that intermediary fees for the city's long-term issues averaged 5 percent of the total long-term debt issued.

BENEFITS TO THE COMMUNITY

The community benefits from the sale of these 18 tax-exempt securities, according to city officials. One benefit is that urban blight has been and will continue to be reduced by the construction and rehabilitation of buildings in the downtown Oakland area. This bond-financed construction, according to city officials, also generates private construction and rehabilitation of buildings in the area. This further reduces the blight while increasing the tax base. One example of a privately funded rehabilitation project stimulated by the tax-exempt construction of other buildings is a multistory building on Broadway Street, across from city hall.

Oakland expects the two multifamily housing projects to add a total of 757 units to the city's housing stock, including 300 units for the elderly and at least 158 units for low- and middle-income families. Also, some low- and middle-income families, according to Oakland's projections, will be able to purchase homes as a result of the single-family mortgage subsidy bond issue. The city had projected it would be able to purchase mortgages for about 200 families when the bonds were issued. However, a city housing official in May 1986 said he did not expect Oakland to purchase that many because conventional mortgage rates have dropped to a level comparable to the subsidized rate of 9-7/8 percent.

The city also expects the community to benefit from increased availability of medical services through two small bond issues and increased commercial, recreational, and public services from five other bond issues.

Construction employment, according to Oakland officials, has increased because of these projects. Twelve tax-exempt issues involve construction or rehabilitation of buildings and city properties. Information on the amount of construction labor on these projects was not available from city records.

BENEFITS TO THE CITY GOVERNMENT

According to city officials, the city has benefited and will continue to benefit from these 18 tax-exempt issues because (1) it has been able to pay its bills on time, (2) its unfunded pension liability has decreased, and (3) its property tax base has increased.

The tax and revenue anticipation notes have helped enable the city to pay its bills on time, thus avoiding interest costs and possible late charges, according to city officials. The note sales brought in needed cash early in the fiscal year and thus helped the city meet its obligations to its creditors, employees, and citizens.

City officials said that the sale of the pension financing certificates has reduced the city's unfunded police and fire fighter pension liability. They pointed out that the sale of the small issue industrial development bonds, the tax allocation bond, the sale and leaseback of the Scotlan convention center, and the capital improvement financing certificate have increased the property tax base. They believe the base will continue to increase because of the commercial development and capital improvements that have been undertaken with the proceeds of these sales. This increase in the property tax base will mean an increase in the city's tax revenues. We were unable to quantify these increases in property tax revenues due to the construction or rehabilitation undertaken with these securities' proceeds because of the time constraints of our review.

In addition, according to a city official, the city is receiving arbitrage profits on the Scotlan convention center sale proceeds while the city holds the proceeds for funding capital improvements to city property.[2] We were unable to quantify these earnings because they are not segregated from the investment earnings of two other tax-exempt issues sold before January 1, 1983.

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[2]While current law restricts arbitrage on bond proceeds, it does not restrict how the city can use sale proceeds. Thus, the city is able to invest this money in relatively high yielding securities.

SECTION 4

LEGAL UNCERTAINTIES RAISED BY

OAKLAND'S PROPOSED PRIVATE LOAN

In January 1986 several newspapers reported that the city of Oakland planned to loan the Oakland Athletics (A's), a baseball team, $15 million. These newspapers reported that the plan was to issue a tax-exempt bond for capital improvements and equipment. The bond proceeds would allow the city to free up money in the general fund that had been dedicated to the purchase of police and fire equipment. This freed up money would then be used to make a loan to the A's. According to the newspapers, debate in the city council revolved around using general fund money for the A's when pressing community needs would go unmet. One City Councilman, according to a Bond Buyer article, while opposed to the use of general fund money for this purpose praised the City Manager "for 'leading the way' in efforts to circumvent federal restrictions on tax-exempt financing."

In an attempt to clarify the issue, the City Manager prepared a memorandum on the proposed A's loan that was discussed before the council in April 1986. In it, he presented background information explaining that the current coliseum lease with the A's will expire in 1987, that the faltering financial condition of the team increased the possibility that the team could move to another city, but that with a $15 million loan and certain other conditions the A's would agree to remain in Oakland until the year 2000. The memorandum went on to explain that funding for this proposed loan would not come out of bond proceeds nor the general revenue fund. Instead, the memorandum proposed that the money for a loan to the A's be taken from "the City's cash management accounts which are offsetting assets in relation to the liabilities incurred" for capital improvements.

The city's Finance Director explained that offstreet parking funds in three cash management accounts had been transferred to the unrestricted general fund[1] and the accounts closed in November or December 1985. To close these accounts, which were set up to assure bond holders of repayment and consisted of

[1]The specific account within the general fund was a multipurpose account, separate and distinct from the main general fund account.

revenues from parking fees and fines, Oakland had to defease[2] two earlier bond issues used to fund offstreet parking. This action also eliminated certain restrictive covenants (that is, the parking fees and fines were dedicated to these accounts). It defeased these issues with funds from the August 1985 sale of 23 properties. (See app. VIII.)

By defeasing these bonds and canceling the outstanding parking projects, Oakland freed $12-13 million in parking revenues to be transferred to the unrestricted general fund, according to the Finance Director. He said that these revenues were spent on city operations, while $15 million in the unrestricted general fund was designated for a loan to the A's.[3] Meanwhile, the parking projects were funded anew with certificates of participation in December 1985. (See fig. 4.1.)

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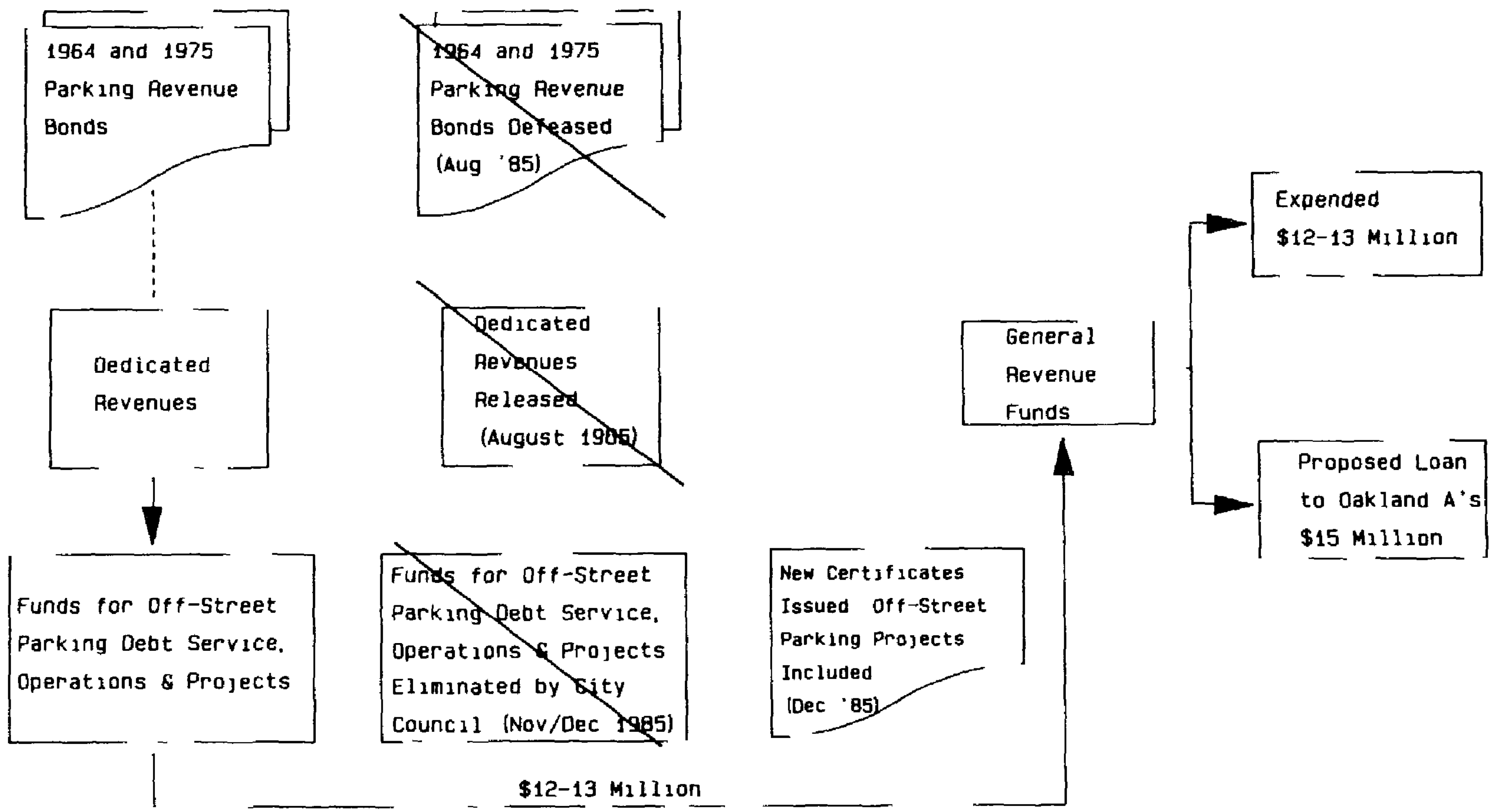
[2]Defeasing a bond is discharging the lien of an ordinance, resolution, or indenture relating to a bond issue and, in the process, rendering inoperative restrictions under which the issuer had been obliged to operate. To defease the bonds, Oakland set aside money with an escrow agent to pay off these bonds when they matured or could be redeemed. One bond issue matured December 1985, the other was redeemed January 1986.

[3]The city council subsequently approved a $15 million loan to the A's on July 15, 1986.

FIGURE 4.1

City's Proposed Loan to Oakland Athletics



Whether money for the proposed loan comes out of the unrestricted general fund or another account, the series of transactions makes it difficult to determine if the proposed loan is indeed bond financed. Two provisions in the tax code suggest that the federal government intended to limit the use of tax-exempt bonds. One deals with private loan bonds, the other with the concept of replacement. Section 103(o) of the Internal Revenue Code of 1954, as amended, provides that the interest on state and local government bonds is taxable if the bonds are private loan bonds, i.e., if 5 percent or more of the bond proceeds is to be used to finance (directly or indirectly) loans to persons other than state or local governments. Exceptions to this section include qualified student loan bonds, qualified mortgage bonds, and industrial development bonds. With respect to replacement, current law stipulates under section 103(c)(2)(B) that tax-exempt bonds the proceeds of which were used to replace funds to obtain a materially higher yield than the yield on the bonds are termed arbitrage bonds and would lose their tax exemption. Oakland's bond counsel told us that (1) he was aware of both provisions and (2) Oakland was in compliance with the law with respect to both of these provisions.

We spoke with two attorneys at the IRS to obtain their unofficial views on how far the statute goes in defining the concept of indirect loans and how Oakland's proposed loan fits that definition. One attorney said that what Oakland has proposed is beyond any current IRS ruling. According to this attorney, it would be extremely difficult to determine whether the various transactions undertaken by Oakland resulted in an obligation that could be considered a private loan bond and thus subject to loss of tax-exempt status.

Another IRS attorney explained that the legal concept of replacement is used to determine whether tax-exempt issues can be considered arbitrage bonds. He said that, if so, the interest earned by the bond holder is no longer tax exempt.[4]

This IRS attorney told us that the law is fairly restrictive in its use of the replacement concept, and that both sections 103(b) and 103(c) contain prohibitions on tax-exempt financing. Section 103(b) applies to industrial development bonds and section 103(c) to arbitrage bonds. While replacement is a prohibition on arbitrage bonds, it is not listed as a prohibition for industrial development bonds. His opinion was that, as long as Oakland is not investing in materially higher yielding securities, replacement under current law does not apply.

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[4]For more information on how the IRS has applied the replacement concept see Rev. Rul. 82-101.

CONCLUSIONS

Because of the fungibility of money, it is unclear whether Oakland's proposed loan to the A's is bond financed. Some could argue that the bond issue and the proposed loan are two separate transactions. It could be viewed by others as a series of transactions having the same economic effect as if Oakland had issued an industrial development bond and then loaned the money from that bond to its baseball team. The difference is that if Oakland had attempted to obtain tax-exempt status for an industrial development bond in which 25 percent or more of the proceeds would have been used for a loan to the A's, it might not have been able to comply with all of the restrictions under section 103(b). It appears, however, that Oakland may be able to obtain the same economic effect through a series of accounting transactions that place money into a fund that is not restricted in the same manner as the city's bond funds.

MATTERS FOR CONSIDERATION BY THE CONGRESS

Since it is unclear whether current tax law provisions apply to Oakland's proposed loan to the A's, the Congress may want to clarify its intent. The key issue is how far the statute goes in defining the concept of indirect financing. Should a clarification be warranted, there are at least two possible alternatives. One alternative is to change the language of current tax law provisions to clarify the restrictions on uses of tax-exempt financing. Another alternative is to direct IRS to determine the extent to which tax-exempt bonds are being used for private purposes and, if warranted, to determine what is needed to correct the situation.

OAKLAND'S 18 TAX-EXEMPT FINANCING

TRANSACTIONS ISSUED BETWEEN

JANUARY 1, 1983, AND MAY 31, 1986

 APPENDIX I

Oakland's 18 Tax-Exempt Transactions
Issued between January 1, 1983, and May 31, 1986

Type and Name of Issue	Date of Issue (a)	Amount of Issue	Interest Rate (percent)	Term or Serial (years)	Final Payment Date	Estimated Present Value of Interest Payments Over Life of Issue
TAX AND REVENUE ANTICIPATION NOTES						
1985 Notes	7-1-85	$35,700,000	4.7	Term 01	7-30-86	$1,683,752
1984 Notes	7-10-84	29,800,000	7.5	Term 01	6-28-85	1,924,893
1983 Notes	7-21-83	26,000,000	7.45	Term 01	7-18-84	1,752,608
Subtotal short-term debt		$91,500,000				$5,361,253
HOUSING BONDS						
Skyline Hills Multifamily Rental Revenue Bonds	1-1-85	23,000,000	Variable	Term 24	1-01-09	13,741,540 (b)
Lake Point Towers Multifamily Housing Revenue Bonds	12-01-85	38,000,000	6.625 (d)	Term 23	12-01-08	22,291,636 (b)
Issue C Housing Finance Revenue Bonds	5-15-85	23,175,000	6.00-9.125	Serial and Term 32 (e)	3-15-17	7,724,078 (c)

Legend N/A means not applicable.

Footnotes
(a)This is the date on which interest begins accruing.

(b)The developer or nonprofit organization who receives the bond proceeds pays the interest and commissions and fees.

(c)This estimate is based on the assumption that the city will redeem half of the bonds on March 15, 1987.

(d)The fixed rate can be periodically reset.

Total Estimated Commissions and Fees Paid by City	Total Estimated Fees Received By City	Estimated Present Value of Gross Federal Revenues Foregone	Estimated Present Value of Adjustments to Federal Revenues Foregone	Estimated Present Value of Net Federal Revenues Foregone	Estimated Present Value of California Revenues Foregone
$75,275	N/A	$1,087,444	(f)	$1,087,444	$63,317
42,827	N/A	1,245,207	(f)	1,245,207	84,340
60,395	N/A	595,438	(f)	595,438	73,094
$178,497		$2,928,089		$2,928,089	220,751
(b)	301,000	8,800,390	4,400,195	4,400,195	833,892
(b)	1,312,500	11,995,424	5,997,712	5,997,712	1,247,444
1,558,734	94,221	2,642,451	1,321,225	1,321,225	447,378

e)Term bonds will be retired with mandatory sinking fund payments.

)Adjustments were not estimated for public purpose bonds.
e app. IX for an explanation.

Oakland's 18 Tax-Exempt Transactions
Issued between January 1, 1983, and May 31, 1986

Type and Name of Issue	Date of Issue (a)	Amount of Issue	Interest Rate (percent)	Term or Serial (years)	Final Payment Date	Estimated Present Value of Interest Payments Over Life of Issue
SMALL-ISSUE INDUSTRIAL DEVELOPMENT BONDS						
Old Oakland Company Project	12-14-84	9,900,000	Variable (Max 15)	Term 15	12-7-99	5,083,576 (b)
Delger Block/ Ross House Company Project	12-14-84	9,500,000	Variable (Max 15)	Term 15	12-7-99	4,878,179 (b)
Wilcox/Lelmert Company Project	12-14-84	9,500,000	Variable (Max 15)	Term 15	12-7-99	4,878,179 (b)
East Bay Outpatient Surgery Center Project	12-20-84	3,000,000	Variable (Max 12)	Term 20	12-1-04	1,676,268 (b)
Cardio-pulmonary Building Project	12-18-85	2,500,000	Variable (Max 12)	Term 20	12-1-05	1,591,691 (b)
Association of Bay Area Governments	12-27-84	3,300,000	Variable (Max 15)	Term 25	12-1-09	1,948,283 (b)
Oakland Young Men's Christian Association Project	4-1-85	8,900,000	6-9.25	Term 20	4-1-05	4,946,687 (b)

Legend N/A means not applicable

Footnotes
(a)This is the date on which interest begins accruing.

(b)The developer or nonprofit organization who receives the bond proceeds pays the interest and commissions and fees.

Total Estimated Commissions and Fees Paid by City	Total Estimated Fees Received By City	Estimated Present Value of Gross Federal Revenues Foregone	Estimated Present Value of Adjustments to Federal Revenues Foregone	Estimated Present Value of Net Federal Revenues Foregone	Estimated Present Value of California Revenues Foregone
(b)	49,500	3,410,203	1,705,101	1,705,102	276,366
(b)	47,500	3,272,417	1,636,208	1,636,208	265,200
(b)	47,500	3,272,417	1,636,208	1,636,208	265,200
(b)	92,200	1,122,685	561,343	561,343	98,443
(b)	77,500	573,077	286,538	286,538	82,035
(b)	Unknown	1,305,670	652,835	652,835	120,301
(b)	56,500	1,929,236	964,618	964,618	275,951

Oakland's 18 Tax-Exempt Transactions
Issued between January 1, 1983, and May 31, 1986

Type and Name of Issue	Date of Issue (a)	Amount of Issue	Interest Rate (percent)	Term or Serial (years)	Final Payment Date	Estimated Present Value of Interest Payments Over Life of Issue
CERTIFICATES OF PARTICIPATION						
Scotlan Convention Center	12-1-83	38,000,000	10.25	Serial and Term 31	9-1-14	30,519,311
Pension	8-1-85	221,540,000	5.50-9 25	Serial	8-1-16	145,344,990
Capital Improvements	12-1-85	52,300,000	Variable (Max 12)	Serial	12-1-15	32,489,272
OTHER BONDS						
Medical Hill Special assessment Parking District Bonds	7-2-84	4,800,000	7.00-10.40	Serial	7-2-04	2,824,563
Tax Allocation Series B	12-1-84	50,000,000	8.50-12 00	Serial	12-1-14	39,239,513
Subtotal long-term debt		$497,415,000				$319,177,766 (g)
Total debt		$588,915,000				$324,539,019

Legend N/A means not applicable.

Footnotes
(a)This is the date on which interest begins accruing

(f)Adjustments were not estimated for public purpose bonds.

(g)The estimated present value totals in this appendix and in Chart 2.1 are slightly different due to rounding.

Total Estimated Commissions and Fees Paid by City	Total Estimated Fees Received By City	Estimated Present Value of Gross Federal Revenues Foregone	Estimated Present Value of Adjustments to Federal Revenues Foregone	Estimated Present Value of Net Federal Revenues Foregone	Estimated Present Value of California Revenues Foregone
2,639,946	N/A	5,091,514	(f)	5,091,514	1,910,535
9,374,235	N/A	42,854,640	(f)	42,854,640	8,452,488
3,969,353	N/A	13,993,914	(f)	13,993,914	1,719,686
431,698	2,280	1,001,626	(f)	1,001,626	175,957
2,687,282	N/A	5,900,964	(f)	5,900,964	2,508,789
$20,641,248	$2,080,701	$107,166,628	$19,161,983	$88,004,642	$18,679,645
$20,819,745	$2,080,701	$110,094,717	$19,161,983	$90,932,731	$18,900,594

Descriptive Information on Oakland's
18 Tax-Exempt Transactions

Type and Name of Issue	Underwriter	Bond Counsel	Trustee	Is Issue Insured?	Bond Rating	Use of Funds	Source of Payment
TAX AND REVENUE ANTICIPATION NOTES							
1985 Notes	Security Pacific National Bank, and Cartwright & Daniels	Brown, Wood, Ivey Mitchell & Petty and Hunter and Anderson	First Interstate Bank of California	No	MIG-1 (a)	To even out cash flows	Certain unrestricted general fund taxes and revenues received in fiscal year 1986
1984 Notes	Crocker National Bank	Brown, Wood Ivey, Mitchell & Petty	Bank of California	No	MIG-1 (a)	To even out cash flow	Certain unrestricted general fund taxes and revenues received in fiscal year 1985
1983 Notes	Bank of America NT&SA	Orrick, Herrington and Sutcliffe	Bank of America NT&SA	No	MIG-2 (a)	To even out cash flow	Certain unrestricted general fund taxes and revenues received in fiscal year 1984
HOUSING BONDS							
Skyline Hills Multifamily Rental Revenue Bonds	Security Pacific Capital Markets Group	Orrick, Herrington and Sutcliffe	Bank of California	Letter of Credit	Aaa/MIG-1 (a)	To construct rental housing project	Revenue from rental receipts
Lake Point Towers Multifamily Housing Revenue Bonds	Goldman Sachs & Company of New York	Brown Wood, Ivey Mitchell & Petty and Alexander, Millner & McGee	Security Pacific National Trust Company	No	not rated as of May 31, 1986	To construct rental housing project	Revenue from rental receipts
Issue C Housing Finance Revenue Bonds	Goldman, Sachs & Company of New York	Orrick, Herrington and Sutcliffe	Security Pacific National Bank	No	A (a)	To purchase single-family mortgages	Revenue from mortgage repayments

Footnotes
(a)Rated by Moody's Investors Service, Inc

APPENDIX II

Descriptive Information on Oakland's
18 Tax-Exempt Transactions

Type and Name of Issue	Underwriter	Bond Counsel	Trustee	Is Issue Insured?	Bond Rating	Use of Funds	Source of Payment
SMALL-ISSUE INDUSTRIAL DEVELOPMENT BONDS							
Old Oakland Company Project	Capital Markets Group, Citibank,N.A. (c)	Orrick Herrington and Sutcliffe	Union Bank	Letter of Credit	AA+/A-1+ (b)	Historical rehabilitation commercial/office	Revenue from loan repayment
Delger Block/ Ross House Company Project	Capital Markets Group Citibank,N.A. (c)	Orrick, Herrington and Sutcliffe	Union Bank	Letter of Credit	AA+/A-1+ (b)	Historical rehabilitation commercial/office	Revenue from loan repayment
Wilcox/Leimert Company Project	Capital Markets Group, Citibank,N.A. (c)	Orrick, Herrington and Sutcliffe	Union Bank	Letter of Credit	AA+/A-1+ (b)	Historical rehabilitation commercial/office	Revenue from loan repayment
East Bay Outpatient Surgery Center Project	Dowdell Corp. (c)	Orrick, Herrington and Sutcliffe	Bank of California	Letter of Credit	Aa1 (a)	Outpatient surgical center	Revenue from loan repayment
Cardio-pulmonary Building Project	Morgan Guaranty Trust Co. (d)	Orrick, Herrington and Sutcliffe and Hunter & Anderson	Security Pacific National Bank	Letter of Credit	Pending	Medical office	Revenue from loan repayment
Association of Bay Area Governments	Bankers Trust Co.	Orrick, Herrington and Sutcliffe	Bank of California	Letter of Credit	Unknown	Acquisition of office space	Revenue from lease payments
Oakland Young Men's Christian Association Project	Drexel Burnham Lambert Inc.	Brown Wood, Ivey, Mitchell & Petty	Manufacturers Hanover Trust Co. of California	Letter of Credit	Aaa (a)	Construction of building	Revenue from loan repayment

Footnotes
(a)Rated by Moody's Investors Service, Inc.

(b)Rated by Standard & Poor's Corporation.

(c)Placement Agent. This firm negotiated the purchase with an institution on behalf of the city

(d)Purchaser. This firm bought the bonds directly from the city.

Descriptive Information on Oakland's
18 Tax-Exempt Transactions

Type and Name of Issue	Underwriter	Bond Counsel	Trustee	Is Issue Insured?	Bond Rating	Use of Funds	Source of Payment
CERTIFICATES OF PARTICIPATION							
Scotian Convention Center	Goldman Sachs & Company of New York	Orrick, Herrington and Sutcliffe	Bank of America NT&SA	No	A (f)(g)	Certificate proceeds to buy Scotian Center. Sale Proceeds to finance capital improvements	Lease payments and letter of cred t
Pension	Goldman, Sachs & Co. Grigsby, Brandford & Co Pryor, Gorvan, Counts & Co.	Orrick, Herrington and Sutcliffe and Alexander, Burris, Millner & McGee	Bank of America NT&SA	$56,315,000 Insured	A (h) AAA (i) (f)	Certificate proceeds to buy 23 properties. Sale proceeds to fund pension liability	Lease payments
Capital Improvements	E.F. Hutton & Co. Grigsby, Brandford & Co.	Orrick, Herrington and Sutcliffe	Bank of America NT&SA	Letter of Credit	Not rated as of May 31, 1986	To fund capital improvements	Lease payments
OTHER BONDS							
Medical Hill Special assessment Parking District Bonds	Paine Webber	Sturgis, Ness, Brunsel & Sperry	Bank of America NT&SA (e)	Insured	AAA (b)	Construction of parking garage	Collection of special assessments
Tax Allocation Series B	Paine Webber Jackson & Curtis Inc. (d)	Orrick, Herrington and Sutcliffe	Crocker National Bank	Insured	Aaa (a) AAA (b)	Redevelopment	Tax Increment

Footnotes

(a)Rated by Moody's Investors Service, Inc

(b)Rated by Standard & Poor's Corporation.

(d)Purchaser. This firm bought the bonds directly from the city.

(e)The bank serves as the paying agent, the transfer agent, and the registrar, but it does not act as a trustee. The City holds the bond proceeds and transfers money into the bank account as needed to make principal and interest payments on the bonds.

(f)The city could not provide documentation to substantiate the rating.

(g)Rated by Fitch Investors Service, Inc.

(h)Rating for the certificates that were not insured.

(i)Rating for the certificates that were insured

APPENDIX II

TAX AND REVENUE ANTICIPATION NOTES

Since January 1, 1983, the city of Oakland has issued three short-term tax and revenue anticipation notes totaling $91.5 million. The city has paid off the first two issues, leaving $35.7 million outstanding as of May 31, 1986. The third issue is due to be retired July 30, 1986. The money from these three issues has been used to meet the city's general fund expenditures, including operating and capital expenses.

PURPOSE

Tax and revenue anticipation notes are short-term, general obligations which are usually under 1 year. The city issued them to maintain its cash flow in anticipation of taxes and other revenues to be received by the city's general fund later in a fiscal year. Although these are general obligation notes, they are payable only out of the taxes, revenues, and other moneys that are otherwise uncommitted.

The city issued these notes to correct the imbalance in the city's receipts and expenditures, that is, the cash flow. City records show general fund expenditures tend to exceed the receipts early in the fiscal year primarily because of property tax installment payments. The city receives these taxes (an important source of revenue) from the county of Alameda in December and April of each year. However, the city's fiscal year begins July 1 and the projected cash in the city's coffers was not sufficient to cover the projected expenditures during the early part of fiscal years 1984, 1985, and 1986.

COSTS

The city will pay a total of $5.4 million in interest and $178,000 to sell and administer the three issues. The selling costs included $28,000 to bond counsel.[1] These issues will cost the federal government an estimated $2.9 million in lost income tax revenues, and will cost California an estimated $221,000 million in lost personal income tax revenues.

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[1]The bond counsel fees for the 1984 notes were $7,500, according to the city's Finance Director. The other years' fees were based on city records.

BENEFITS

These notes have allowed Oakland to pay its bills on time, according to city officials. The community benefits, according to city officials, because the city continues to provide the services that citizens and visitors are accustomed to. Financing intermediaries benefit to the extent that this method of financing creates additional demand for their services. Intermediaries received $178,000, less than 1 percent of the notes' proceeds.

SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS

The city of Oakland has sold seven small issue industrial development bonds since January 1, 1983. The aggregate amount of these issues is $46.6 million.

PURPOSE

Small issue industrial development bonds are a type of tax-exempt revenue bond that state and local governments can issue to provide financing for private firms. The bonds are secured by revenues of the bond-financed property and are not an obligation of the city itself.

Five of the seven bond issues were for loans to private firms to develop medical facilities and to rehabilitate historical structures for commercial and retail use. The remaining two bonds were issued for the benefit of nonprofit organizations: one for a loan to the Young Men's Christian Association (YMCA) for construction of a new headquarters building and the other issue for the acquisition of office condominium space to be leased and subsequently owned by a regional planning agency.

COSTS

All costs associated with the bonds are paid or reimbursed by the private firms or nonprofit organizations benefiting from the bond proceeds. This includes bond application, contract compliance, and administration fees to Oakland of $370,700 from six of these entities to offset city staff time and services involved over the life of each issue. We could not determine from city records if the fees received were below, just met, or exceeded city costs. We estimate the interest costs to be $25.0 million (in present value terms).

We estimate the cost of tax-exempt financing to the U.S. Treasury at $7.4 million and to the state of California at $1.4 million (in present value terms).

BENEFITS

Industrial development bonds have provided the city with a low or no cost financing method to develop and attract new businesses and services for the community. Also, the financing of private endeavors allows the city to control and place requirements on private projects in areas such as hiring practices. For example, the city requires developers to hire construction workers from the Oakland area.

Benefits to the community are derived from the increase in services and jobs provided by the new businesses and medical and recreational facilities financed with the bonds. The city also mandates and monitors affirmative action, minority, and equal employment opportunity practices of the private firms benefiting from the use of city financing. For example, a goal of the Affirmative Action Employment Program is 50 percent minority employment in construction contracts.

The private firms and nonprofit organizations using the bond proceeds benefit from the lower interest costs of tax-exempt financing. However, these entities also experience an increase in paperwork and requirements imposed by the city for use of these funds.

All local taxing entities benefit from stimulation of the economy due to new business. Income is generated for these entities with an increase in jobs, licenses, and property values, as well as increased sales of goods or services.

The transactions benefit financing intermediaries involved in the issue and administration of the bond to the extent that these issues increased the demand for their services. We did not attempt to estimate income received by these entities for issuance and ongoing administrative services since this data was not available in the city's files.

HOUSING BONDS

Since January 1, 1983, Oakland has sold three tax-exempt bond issues totaling $84 million to finance housing. These bonds were issued to increase the availability of housing, including housing for the elderly and for those with low to moderate income.

PURPOSE

The three issues are commonly referred to as Skyline Hills, Lake Point Towers, and Issue C. The first two are to finance the construction of multifamily rental housing; Issue C is to purchase mortgages for constructing, rehabilitating, or purchasing single-family homes.

These three issues are revenue bonds. The bond principal and interest will be paid from rental receipts for Skyline Hills and Lake Point Towers and from the mortgage payments for Issue C. The only assets that have been pledged to repay the bonds are these revenues.

On January 1, 1985, Oakland issued $23 million in Skyline Hills bonds to build 299 garden apartments in 45 two-story buildings. The city required that 66 of the 299 units (or 22 percent) will be rented to individuals whose income is below 80 percent of the median income level for Oakland. Ten of these 66 units will be rented to tenants whose income is below 65 percent of the median income level. The project is scheduled to be finished in early fall 1986.

On December 1, 1985, the Redevelopment Agency issued $38 million in Lake Point Towers bonds to build 458 rental units, including 300 units for the elderly. The city has required that the developer rent at least 20 percent of the units to individuals whose income does not exceed 80 percent of the median income for the area. The agency issued these bonds because the city had already issued the maximum annual total of housing bonds allowed by federal and state law.

The agency plans to loan the bond proceeds to a developer who will construct the project. First, the developer must obtain a rating on the bonds and then either acquire a construction loan to begin the project or provide security for the loan in the form of insurance. As of June 5, 1986, the agency had not loaned the bond proceeds to the developer because these conditions had not yet been met.

The city sold $23 million in Issue C bonds on May 15, 1985. With the proceeds of the Issue C bonds the city originally intended to purchase about 200 mortgages for owners of single-family homes. However, in May 1986 a city housing official said the city will probably be able to purchase only about half the number of planned mortgages, because the 9-7/8-percent interest rate is not significantly lower than the current market rate. Furthermore, the city must purchase the mortgages before June 18, 1988, when all bond proceeds not already used to purchase mortgages must be used to redeem the bonds. As of March 31, 1986, 10 months after the bonds were issued, the city had purchased 34 mortgages for $2.3 million.

COSTS

The developers will pay the costs to sell and administer the Skyline Hills and Lake Point Towers issues. Over the lives of these two issues, the developers will reimburse the city an estimated $1.6 million for its administrative costs. The developers' interest cost for these two issues will be $13.7 million for Skyline Hills and $22.3 million for Lake Point Towers (in present value terms).

The city will pay an estimated $1.5 million to sell and administer Issue C. It incurred costs of $800,000 to sell the issue, including $56,000 for the bond counsel. In addition, it will pay an estimated $739,000 in administrative costs over the life of the issue. Administrative costs consist of

--fees paid to the bank for such services as paying the interest to the bondholders,

--fees paid to the financial institutions who will service the mortgage loans for the city,

--premiums paid to insurance companies for mortgage insurance and Federal Housing Administration mortgage pool insurance, and

--fees paid to cover the city's staff time to monitor and approve all mortgages purchased under the Issue C subsidy program.

We estimate the city's interest cost for Issue C at $7.7 million (in present value terms). This estimate is based on the assumption that the city will use half the Issue C bond proceeds to purchase mortgages and the other half to redeem bonds on March 15, 1987. The city's principal and interest costs will be covered by payments from the mortgages.

We estimate that these issues (in present value terms) will cost the federal Treasury $11.7 million in lost income tax revenues and the state $2.5 million.

BENEFITS

Skyline Hills and the Lake Point Towers bond issues have enabled the city government to meet its obligation as stated in the 1985/1986 adopted policy budget to "provide planning, program development, and administrative services for the development of low- and moderate-income housing projects." With the Issue C bonds, the city sought to (1) increase the supply of funds available for mortgages, (2) encourage residents to move into target areas, and (3) encourage new construction of homes.

With the completion of Skyline Hills and Lake Point Towers, Oakland rental housing will be increased by 757 units. Of these, 300 will be for elderly renters and at least 158 will be rented to low- and moderate-income individuals.

Issue C bonds provide the community with a pool of funds for mortgages at 9-7/8 percent. As of March 31, 1986, 34 families had taken advantage of this mortgage subsidy program.

The financing intermediaries received all the fees paid by the city to sell and administer the Issue C bonds--$1.5 million or 6.6 percent of the total bond sale proceeds.

The developers of Skyline Hills and Lake Point Towers benefit from lower financing costs, which may enable them to earn a greater rate of return than is available from alternative investments, including conventionally financed construction or rehabilitation loans.

SPECIAL ASSESSMENT DISTRICT BOND

Since January 1, 1983, Oakland has sold one issue of $4.8 million tax-exempt special assessment district bonds to finance the construction of a parking garage for a hospital complex in Oakland. The city established a special tax district, comprising 19 parcels of land owned by the hospital complex, and then levied a special property tax assessment on the district.

PURPOSE

The city is using the proceeds with $1.9 million from parking revenues to build a 5-level, 487-stall parking garage. The parking garage became fully operational in the spring of 1986. The city owns and operates the garage through a parking commission. The garage is located on city-owned land across the street from a privately owned medical center.

These bonds are limited liability debt; that is, they will be paid from the special assessment portion of the hospital complex's annual property tax payments. The only assets that have been pledged to repay the bonds are these assessment revenues.

COSTS

Oakland will pay an estimated $432,000 to sell and administer the bonds, including $64,000 for the bond counsel.

To repay the bonds will cost the Merritt Peralta Medical Center $11.6 million over a 20-year period. This total comprises

--the $4.8 million principal,

--$6.8 million interest, and (or $2.8 million in present value terms)

--$2,280 in collection fees.

We estimate that the bonds will cost the U.S. Treasury $1.0 million and California $176,000 in lost income tax revenues (in present value terms).

BENEFITS

The city now owns a parking garage which generates revenues. Revenues beyond those required to pay the garage's operating costs will be used to redeem bonds early, or they will be credited to the city's general fund after the bonds have been retired.

The community benefits from over 480 parking spaces provided at the hospital complex. The financing intermediaries received \$432,000 (9 percent of the issue) or all the commissions and fees paid by the city.

TAX ALLOCATION BOND

Since January 1, 1983, the Oakland Redevelopment Agency has issued one tax allocation bond series, the Central District Redevelopment Project Tax Allocation Bond, Series B, for $50 million. In June 1986 the Agency refunded this bond to take advantage of lower interest rates available at that time.

PURPOSE

Tax allocation, or tax increment, bonds are a method of funding capital improvements in a redevelopment district. Redevelopment results in increased property values, which increases property tax revenues. The increase in property tax revenues over the pre-redevelopment base amount is known as the tax increment. The increment is pledged to repayment of bonds issued for redevelopment. After all bonds are repaid, the tax increment is paid to all of the local taxing entities within the project area.

The proceeds of the Series B bond issue are being used to fund capital projects within a redevelopment area which consists of more than 200 blocks, including the entire central business district of Oakland. According to Agency records, as of June 5, 1986, allocation of the bond proceeds among the central district projects had been made to 14 projects and actual expenditures had been made to 8 projects totaling $12.8 million. These expenditures paid for the following improvements:

--Low- and moderate-income housing subsidies and public improvements.

--Equipment acquisition, structural upgrading, and staff costs for a farmers' market.

--Leasehold improvements, installment purchase payments, and equipment for a theater.

--Restoration of commercial structures.

--Partial reimbursements to the city for land acquisition, development, and construction of a parking structure.

--Staff cost for implementing foreign marketing strategies.

In addition, $1.4 million was spent for planning, administration, and staff costs.

The bond is expected to fund approximately 22 percent of the total costs estimated for the central district projects. Other projected sources of funding include additional tax allocation bonds, trust account earnings, advances from the city of Oakland, loan repayments, land sale proceeds, and developer contributions.

COSTS

The city incurred bond issuance costs of $2.7 million, including $25,000 for bond counsel. The city will pay an estimated $39.2 million (in present value terms) in interest costs. Estimated bank fees for administration and account maintenance over the life of the bond total $65,000.

The bond interest costs incurred by the city are somewhat offset by the earnings on investment of the unexpended bond proceeds and tax increment which totaled approximately $5 million as of March 31, 1986. We did not attempt to project these investment earnings over the life of the bond issue. In addition, the city projected that when the bond was refunded, interest rate savings of $3.5 million will be realized, assuming reduction in interest rates from 10.10 percent to 7.63 percent.

We estimate the cost of this tax-exempt financing (in present value terms) to the U.S. Treasury at $5.9 million and to California at $2.5 million.

BENEFITS

The city and overlapping taxing jurisdictions benefit from increases in property tax revenue and other fees, licenses and taxes from new businesses. A 1984 report by the city's fiscal consultant projected that after fiscal year 1985, the revenues generated by development of the central district would annually exceed the service costs and reach over $800,000 in fiscal year 1992. These projected revenues are based on the funding received from all the central district project sources. Therefore, the revenue share specific to the Series B tax allocation bond could not be determined.

We could not quantify the benefits to the community derived from the tax allocation bond; however, the bond proceeds should help the community by expanding the supply of low- and moderate-income housing; expanding employment opportunities for jobless, underemployed, and low-income persons; providing public improvements; and providing an environment for the social, economic, and psychological growth and well-being of all citizens.

The transaction benefits financing intermediaries involved in the issue and administration of the bond to the extent that this issue increased the demand for their services. Income received by these entities as of March 31, 1986, for issuance and ongoing administrative services totaled $2.7 million.

CERTIFICATES OF PARTICIPATION

Since January 1, 1983, Oakland and its agencies have issued certificates of participation on three occasions:

--One involved the sale and leaseback of the Oakland Convention Center. The proceeds were used to finance capital improvements.

--A second involved the sale and leaseback of 23 properties. The proceeds were used to fund the city's police and fire fighter pension system.

--A third involved the construction and lease of various capital improvements.

DESCRIPTION AND PURPOSE

The certificates were issued through the Bank of America as trustee and entitle the investors to a share of either the lease payments or the installment purchase payments. The trustee holds the bond or sale proceeds in the city's account, which the city draws on as needed. For the convention center and pension transactions, the city makes semiannual lease payments from its general fund to the purchaser's account which is held by the trustee. The trustee then makes interest payments from the purchaser's account to the investors, who are repaid their principal when the certificates mature. If the lease or purchase payments are not adequate to cover the principal and interest, the trustee draws upon a letter of credit, reserve fund or insurance to cover the shortfall.

Certificates of participation were chosen instead of revenue bonds or general obligation bonds because, according to bond counsel,

--No revenue stream was available to repay construction of capital improvements.

--Using revenue bonds for the pension fund would have required establishing a tax-exempt entity to issue the bonds.

--The use of revenue bonds might have hampered the city from using a general credit lease. The city wanted to use such a lease for the convention center and the capital improvements, because it would help to secure the investors' funds.

--State law requires the approval of two-thirds of the city's voters for a general obligation bond, and this is time consuming.

Scotlan Sale and Leaseback

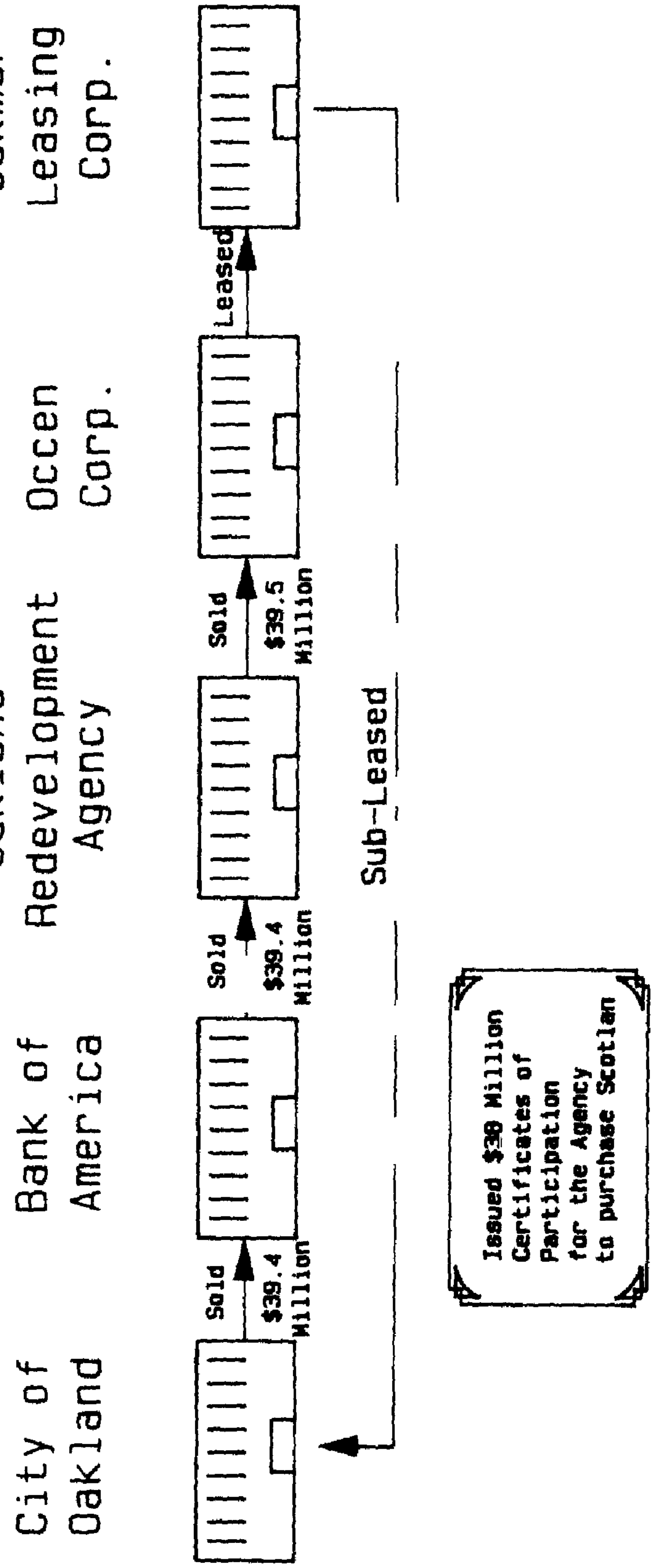
In December 1983, the city sold the Oakland Convention Center, also called the George P. Scotlan Memorial, through the trustee, to the Oakland Redevelopment Agency for $39.4 million to finance various capital improvements, including street resurfacing and sewer modernization. The Agency, through the trustee, issued $38 million in tax-exempt certificates of participation to finance the purchase of Scotlan from the city. These certificates give the investors the right to share in the Agency's purchase payments. The city has an option to buy back the convention center at the end of the 30-year lease.

The sale and leaseback and the issuance of the certificates involved several simultaneous transactions. (See fig. VIII.1.)

APPENDIX VIII

FIGURE VIII.1

Scotlan Convention Center
Sale and Leaseback
(December 1983)



--The city sold Scotlan to the Bank of America National Trust for $39.4 million.

--The Bank of America, as trustee, issued, on behalf of the Agency, $38 million in certificates of participation.

--Bank of America sold Scotlan to the Agency for $39.4 million.

--The Agency sold Scotlan to the Occen Corporation for $39.5 million.

--The Occen Corporation leased Scotlan to the Oakmar Leasing Corporation, which then subleased it to the city.

--Occen deposited a letter of credit with the trustee to cover any difference between what was due to the Agency and what would be received as lease payments, thereby protecting the certificate holders.

--Required payments by all parties were assigned to the trustee to be used to repay the certificate holders.

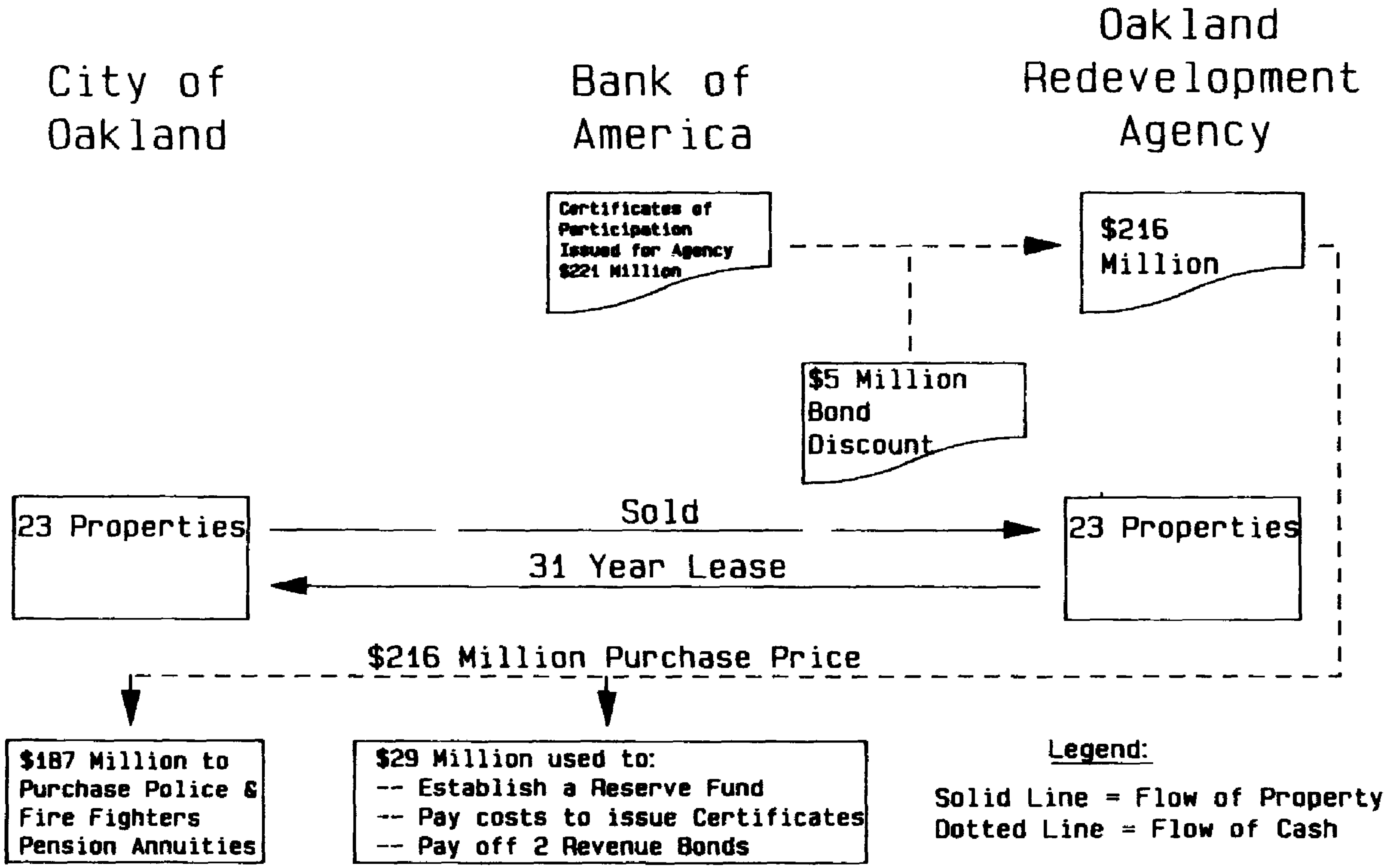
Pension Fund Financing

On August 1, 1985, the city government sold 23 city-owned properties to the Oakland Redevelopment Agency, which then leased them back to the city. To finance its purchase of the properties, the Agency, through the trustee, issued $221.5 million in tax-exempt certificates of participation. These certificates give the investors the right to a share of the purchase payments made by the Agency. The city used the sale proceeds to fund a portion of its police and fire fighter pension system.

The sale-leaseback and the issuance of the certificates involved a number of simultaneous transactions, depicted in figure VIII.2:

FIGURE VIII.2

Pension Fund Financing
Sale and Leaseback



APPENDIX VIII

--The city sold 23 properties to the Agency for $216.2 million.

--The city sold its rights to the sale agreement with the Agency to the trustee for a lump sum of $216.2 million and used the proceeds of that sale to purchase annuities for the pension plan.

--The trustee issued $221.5 million in certificates of participation on behalf of the Agency. The trustee paid $216.2 million to the city to purchase its rights to the sale agreement and $5.3 million to the underwriters.

--The Agency leased the 23 properties to the city, giving it an option to purchase each property for $100 at the end of the 31-year lease.

--The Agency assigned the trustee its rights to the lease payments.

Capital Improvements

In December 1985, the Civic Improvement Corporation, a nonprofit corporation, through the Bank of America as trustee issued variable-rate certificates of participation totaling $52.3 million to finance the acquisition and construction of capital improvements on city property, such as traffic control devices, street resurfacing, parking lots, and garages. These certificates give investors the right to a share in the city's payments to the Corporation to lease the improvements. The lease and the issuance of certificates involved several simultaneous transactions.

--The Corporation agreed to lease the capital improvements to the city from the time they are completed until the year 2015.

--The Corporation assigned to the trustee its rights to the city's lease payments.

--The trustee issued $52.3 million in variable-rate certificates of participation on behalf of the Corporation.

--The city deposited a letter of credit with the trustee for payment of the principal and interest due on the certificates.

According to bond counsel, the certificates were issued to fund future capital improvements. A city official said that the issuance of these certificates of participation allowed the city to take advantage of the arbitrage earnings being realized on the sale proceeds from Scotlan and the Kaiser Convention Center.[1] The sale proceeds, according to the city's bond counsel, are not subject to arbitrage restrictions as are the certificate proceeds. Therefore, the city official said the certificate proceeds would be used for capital improvements before the sale proceeds so that a higher investment yield could be obtained.

COSTS

The city's costs to sell the three issues are estimated at $16 million, including $501,000 for bond counsel. The city will pay an estimated $208 million in interest costs (in present value terms) and $3.8 million in recurring administrative fees.

These costs will be partially offset by the investment earnings on the unexpended certificate proceeds. For two issues, we were unable to obtain estimates of the investment earnings. However, for the pension fund the trustee estimated that earnings over the life of the issue will be $98.8 million. The costs of this issue will also be offset by payments, made by the Parking Authority to the city for retiring its two revenue bonds. The trustee estimated that these payments will total $4.3 million.

We estimate the income tax loss (in present value terms) to the U.S. Treasury at $62.0 million and to California at $12.1 million.

BENEFITS

The city has benefited by being able to structure a pension plan that will be fully funded by the year 2016. Secondly, the monthly annuity payments reduced the city's contributions to the pension plan by that amount. According to a city official, the purchase of the annuities made the plan more financially sound and reduced the total cost of the pension plan to the city. At a cost of $186.5 million, the city purchased annuities that will provide benefits totaling $661.4 million by 2077, according to insurance company estimates. According to the same city official, the retirees benefit by being part of a plan whose

[1]The Kaiser Convention Center sale and leaseback occurred in 1982, and thus was not included in our review.

financial soundness has increased and which will be fully funded by the year 2016.

The other two issues provide benefits in the form of capital improvements. The community and local businesses benefit from street improvements, modernization of the city's infrastructure, and the construction of parking facilities. These improvements also stimulate the local economy. According to a city official, over 90 percent of the capital improvements are performed by private contractors.

According to this same official, the city benefits from the capital lease issue by an increase in funds from which capital improvements can be performed. The use of these certificate proceeds for capital improvements instead of the Scotlan or Kaiser sale proceeds allows the city to earn a higher rate of interest on investment of these unrestricted funds. The Scotlan certificates were issued at 10-1/4 percent, and the Kaiser certificates, at 9-7/8 and 10 percent. Both Scotlan and Kaiser sale proceeds are presently earning interest at 11-1/2 percent.

The financing intermediaries that have provided their services in the issuance of the certificates have benefited by the payments made to them by the city of Oakland to the extent that this transaction increased the demand for their services. Those payments totaled $16 million or 5.1 percent of the certificates issued.

METHODOLOGY USED TO ESTIMATE TAX REVENUE FOREGONE FROM TAX-EXEMPT BONDS

Our estimates use an economic model that describes how, in aggregate, investors adjust their portfolios to accommodate an increased supply of tax-exempt bonds.[1] The results derived from the model are based on three key assumptions: (1) investors are free to move their capital among different investment opportunities to obtain the highest after-tax rate of return; (2) the total pool of savings available for investment is fixed and therefore not affected by an increase in the volume of tax-exempt bonds; and (3) each new issue of tax-exempt bonds is a net addition to the outstanding total of tax-exempt assets including bonds.

The first assumption implies that if competition among borrowers to obtain funds exists, those offering the highest after-tax return (adjusted for risk) will obtain the funds. The second assumption implies that if, at interest rates prevailing before a new tax-exempt issue, all borrowers were able to obtain funds, then an increase in the demand for funds (supply of bonds) will cause interest rates to rise. This increase, which may be quite small, will be necessary to ration a fixed pool of savings for investment among borrowers. As interest rates rise, some borrowers are no longer willing to pay the market rate to obtain investors' savings. Interest rates will stop rising when the new rate is high enough that the available savings from investors is sufficient to allow all borrowers willing to pay that rate to obtain funds.

The key to determining the revenue loss lies in the third assumption. The implication of this assumption is that as interest rates rise to accommodate the increased demand for investor savings, borrowers who become unwilling to pay the market rate are not other municipal and state governments. This is because since no profit motive is involved, government borrowers can be assumed to be less interest-rate-sensitive than

[1]For a more complete description of the methodology, see Eric Toder and Thomas S. Neubig, "Revenue Cost Estimates of Tax Expenditures: The Case of Tax Exempt Bonds," National Tax Journal 38 (September 1985): 395-414.

corporations. If this assumption holds, then investments paying income that is taxable will be replaced in some investors' portfolios by newly issued tax-exempt bonds.[2]

Given these assumptions we applied the following three-step formula to estimate the federal tax loss for each tax-exempt bond issued by the city of Oakland from January 1983 through May 1986. The face value of each new bond was

--multiplied by the interest rate of a comparable taxable corporate bond and then

--multiplied by the percentage difference between the yields of the tax-exempt and taxable bonds, expressed as the following ratio:

$$\frac{\text{taxable yield} - \text{tax-exempt yield}}{\text{taxable yield}},$$

---

[2]Although it is generally believed that the demand of municipal borrowers for funds is less sensitive to interest rate increases than the demand of other borrowers, it is possible that our third assumption will not strictly hold. That is, in aggregate, some of the newly issued tax-exempt bonds might replace other tax-exempt assets in investors' portfolios. If this were to happen, then the reduction in taxable income and, therefore, the reduction in tax revenues would be less.

The reduction in tax revenues would also be less if the second assumption does not strictly hold and, instead, the rise in interest rates resulting from the increased demand for funds (supply of bonds) stimulated saving. If this were to happen, then more savings would be available to ration among borrowers. Therefore, investors would be willing to hold additional tax-exempt bonds without an equivalent reduction in their holding of investments paying taxable income. This implies that the reduction in taxable income and, therefore, the reduction in tax revenues would be less.

--and then adjusted by subtracting the product of the face value of the bond and the difference between the taxable and tax-exempt yields times the marginal tax rate of the beneficiaries of the tax exempt bond.[3]

The first step computes the amount of previously taxable income no longer subject to tax by multiplying the amount of newly issued tax-exempt bonds by the current interest rate for comparable taxable securities. Step two converts this amount into an unadjusted tax loss by estimating the marginal tax rate of those investors who replace their investments that pay taxable income with tax-exempt bonds.[4] These investors are not necessarily the actual purchasers of the new tax-exempt bonds, some of whom, particularly those with very high marginal tax rates, might have bought the bonds to replace other investments paying tax-exempt income. Instead, they are likely to be investors in an income tax bracket for which the after-tax yield from a taxable security is the same as the yield from a tax-exempt bond. For example, assume an investor is in the 30-percent income tax bracket and purchases $10,000 of taxable securities paying an interest rate of 10 percent. This investor would earn interest income of $1,000 ($10,000 x 10 percent) and receive an after-tax yield of $700 ($1,000 minus $300 paid in taxes). Had this same investor purchased comparable tax-exempt bonds paying an interest rate of 7 percent, the yield would also be $700 ($10,000 x 7 percent), thus making the investor indifferent as to which type of security to purchase. Step three assumes tax provisions that reduce borrowing costs produce an offset to the loss of taxable income by an amount equal to the reduced borrowing costs.[5] For example, for private purpose bonds, business borrowers will have higher taxable profits as tax-exempt bonds reduce their deductible

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[3]The beneficiaries here are different than the investors. This point and the reason for the adjustment are discussed in more detail below.

[4]The marginal tax rate, or tax bracket, equals the above ratio and represents the percentage of additional taxable income that would go toward taxes.

[5]Other factors which we have not taken into account because of the difficulty in quantifying them would also influence the calculation of the revenue loss, e.g. accelerated cost recovery system (ACRS) and reinvestment of bond proceeds would increase the revenue loss estimate.

interest expenses.[6] Continuing the example and assuming the beneficiaries of the tax-exempt bonds are in the 40-percent tax bracket, the federal revenue loss of $300 ($10,000 x 10 percent x 30 percent) would be offset by $120 ($10,000 x [10 percent - 7 percent] x 40 percent) for a net revenue loss from this $10,000 bond of $180.[7] Also, for public purpose bonds, reduced borrowing costs reduce taxes paid to state and local governments, some of which are deductible.[8]

In making our actual calculations of the federal revenue loss from the tax-exempt bonds issued by Oakland from January 1983 through May 1986, we used the actual interest rate paid on each bond and the interest rate paid on corporate bonds of comparable risk and maturity. We used the difference in interest

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[6]We assumed that the same project would have been undertaken without tax-exempt financing. To the extent that different projects with greater after-tax profits would have been undertaken had the tax-exempt financing not been available, the offset would be lower. Thus our offset estimate represents an upper bound.

[7]The offset estimate for private purpose bonds is sensitive to the marginal tax rate. We assumed a 50 percent marginal tax rate for private purpose bonds in that the beneficiaries are mainly businesses. In addition we assumed that all of the estimated offset would be reflected in lower interest deductions on firms' federal tax returns, which means that all of the estimated offset to revenues lost would be realized by the federal government. To the extent that the marginal tax rate and proportion of revenue losses recouped are on the high side, the offset estimates represent an upper limit.

[8]Because of data limitations we were not able to estimate an adjustment to revenue losses for Oakland's public purpose tax-exempt bonds. For example, we would need to know the average marginal tax rate of the taxpayers, individual and corporate, in Oakland and the proportion of local taxes paid which they deducted on their federal tax returns.

rates on these to calculate the appropriate marginal tax rate that we used to compute the revenue loss on each individual bond.[9]

Because these bonds generate income over many years, we calculated the tax loss in each year throughout the life of the bond. We then discounted the future tax losses and totaled these discounted values to express the present value of the total revenue loss during the life of the bonds. We used as a discount rate, the rate on a Treasury security of comparable maturity that was sold in the same week as the tax-exempt bond was issued.[10]

Using the method we have described, we estimate that the approximately $589 million of tax-exempt bonds issued by Oakland from January 1983 through May 1986 will result in gross tax revenues foregone of $110 million and net tax revenues foregone of $91 million (in present value terms).

We also estimated the revenue loss to the state from the issuance of the tax-exempt bonds by Oakland using assumptions supplied by the state as to the amount of each bond issue held by California households and the borrowing cost of the state. This estimate was $19 million (in present value terms).

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[9]The tax loss could be less if the supply of new tax-exempt bonds is sufficiently large relative to the existing stock of all assets. We have not changed any results due to this consideration because, in practice, the amount of tax-exempt bonds issued by Oakland has been very small relative to the stock of assets in the economy.

[10]We used this procedure because it conforms to GAO guidelines on choosing a discount rate that reflects the government's borrowing costs. Had we used an 8-percent discount rate, as used by the Department of the Treasury, our estimate of the present value of the revenue loss would have been somewhat higher.

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