TAX-EXEMPT FINANCING:
A PRIMER

Public Finance Network
About the Public Finance Network

Formed in 1988, the Public Finance Network is a coalition of 44 organizations united to preserve state and local government use of tax-exempt finance. Members of the Network represent virtually all segments of local and state governments. For information about the Network and financing issues, contact any of its members, listed in Appendix B, or call or write:

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Introduction

*Tax-Exempt Financing: A Primer* provides those unfamiliar with this financing method with a basic understanding of the issue. The *Primer* is divided into two parts: a series of questions and answers on tax-exempt financing, followed by a summary of federal legislation related to tax-exempt bonds in Appendix A.

The questions and answers are organized in four sections:

- **Fundamentals of Tax-exempt Financing**—Provides basic background and definitions essential to an understanding of tax-exempt financing;

- **Constitutional and Policy Issues**—Describes the effects of the Supreme Court’s 1988 decision on tax-exempt financing and outlines the public policy issues to which Congress should be sensitive in deciding the future of tax-exempt financing;

- **Congressional Actions and Their Effects**—Highlights major changes in tax-exempt bond law, particularly those contained in the 1986 Tax Reform Act, the impact those changes have had on issuers of tax-exempt municipal bonds, and suggests changes to better enable state and local governments to meet their financing needs; and

- **Responses to Questions About Tax-exempt Financing**—Provides answers to some of the questions associated with the use of tax-exempt bonds.

This *Primer* was prepared by staff of the American Public Power Association (APPA) and the Government Finance Officers Association (GFOA) for the Public Finance Network (PFN). The PFN is a coalition of 46 organizations interested in preserving the tax-exempt status of state and local government bonds. A list of PFN members and contact names appears in Appendix B.
What is tax-exempt financing?

*Tax-exempt financing* is used by state and local governments to raise capital to finance public capital improvements and other projects, including infrastructure facilities that are vitally important to sustained economic growth. State and local governments have three means of financing these projects: pay-as-you-go financing, intergovernmental revenues such as grants, and borrowing. Borrowing, or debt financing, is accomplished by issuing bonds to pay for specific projects or services. A *bond* is a debt instrument bearing a stated rate of interest that matures on a certain date, at which time a fixed sum of money plus interest is payable to the bondholder.

Unlike corporate debt issues, the interest received by holders of state and local government bonds (also called *municipal bonds*) is exempt from federal income taxes and may also be exempt from state and local income taxes. Consequently, investors will accept a lower interest rate on tax-exempt issues, which reflects their reduced tax burden. This lower rate reduces borrowing costs for state and local governments by approximately 25 percent.

What types of tax-exempt bonds are issued by state and local governments?

There are two general categories of tax-exempt bonds: *general obligation bonds* and *revenue bonds*. General obligation bonds are backed by the “full faith and credit” of the state or local government that issues the bonds. This means the general taxing power of the jurisdiction is pledged to guarantee repayment of the debt. Revenue bonds are issued for a specific project, such as an electric generating plant, and are paid for from the revenues received from the project. Because they are not backed by the “full faith and credit” of the issuer, revenue bonds generally pay a slightly higher interest rate than general obligation bonds to reflect the fact they are backed by a particular stream of revenue.
Who may issue tax-exempt bonds?

At the present time, tax-exempt bonds may be issued by a state or local government or by special units of government such as authorities, commissions, or districts, as well as by not-for-profit organizations such as hospitals and colleges. These entities are created in accordance with state law and are authorized by the state to issue debt.

What do tax-exempt bonds finance?

In 1998, $320.58 billion worth of municipal bonds were issued, of which $285.9 billion, or 89 percent, were long-term bonds and $34.63 billion were short-term bonds. Of the more than $285 billion of long-term bonds, 56 percent were new issuances and 28 percent represented refundings of previously issued bonds to take advantage of the lower interest rates, and 15 percent were combined issues. The following table lists the categories for which these long-term bonds were issued. The figures were compiled from data contained in *The Bond Buyer 1999 Yearbook*.

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<th>Category</th>
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<tr>
<td><strong>Totals</strong></td>
<td><strong>$285.9</strong></td>
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Who benefits from tax-exempt bonds?

All citizens benefit from tax-exempt bonds. Tax-exempt bonds are used to raise capital to meet the long-term needs of America’s state and local governments. More specifically, tax-exempt bonds are issued by states and localities to build schools, roads, bridges, airports, public power facilities, sewers, hospitals, fire stations, affordable housing, mass transit facilities, colleges and universities, and most public facilities that citizens rely on regularly.

Although the primary beneficiaries of a particular bond issuance are the citizens of the issuing community, the whole is equal to the sum of its parts, and the nation as a whole has a
vital interest in maintaining adequate public facilities to support a dynamic economy. The national interest is well served by keeping state and local government borrowing costs low, thereby providing an incentive for public investment in infrastructure and other facilities.

**Who purchases tax-exempt bonds?**

Most tax-exempt bonds are purchased by individuals. At the end of 1998, of the more than $1.4 trillion of municipal debt outstanding, nearly 72 percent was held by individuals directly through household purchases, and indirectly through mutual funds, money markets, and related holdings. This figure represents a significant shift in the make-up of holders of tax-exempt bonds. Historically, commercial banks purchased the largest proportion of these bonds. In 1975, for example, banks held 46 percent of the outstanding municipal debt while 30 percent was held by individuals. Tax law changes over the years have resulted in changes in the demand for tax-exempt bonds. By 1985, for example, individual holdings had grown to 50 percent and bank holdings had dropped to 31 percent. The 1986 Tax Reform Act brought about the sharpest change in demand for tax-exempt bonds. By the end of 1998, banks held only 7.2 percent of the outstanding tax-exempt debt. The reasons for this shift in demand from institutional to individual purchasers as well as the effect the change has had on the municipal bond market are discussed in Chapter 3.

**How are tax-exempt bonds categorized?**

State and local tax-exempt bonds are divided into two major categories: governmental bonds and private-activity bonds. These categories have been incorporated in the federal income tax code in order to reduce the volume of tax-exempt bonds.

**What is a “governmental” bond?**

Generally, bonds issued to finance facilities that are owned, controlled, and/or operated by a state or local government are categorized as governmental bonds. Governmental bonds are used to finance the construction of public facilities, such as schools, roads, water and sewer systems, gas and electric power facilities, firehouses, and other government-owned capital projects. Governmental bonds are also issued to finance the renovation and expansion of these facilities. There is no specific definition of a governmental bond in the tax code.
Rather, it is the definition of a private-activity bond and the application of the two private business-use tests that determine whether a bond is governmental or private activity.

What is a “private-activity” bond?

A private-activity bond is any bond of which more than 10 percent of the proceeds is to be used in a trade or business of a person or persons other than a governmental unit (except for not-for-profit, tax-exempt organizations), and which is to be directly or indirectly repaid from, or secured by, revenues from a private trade or business. If a bond “fails” these two tests (that is, the private use and repayment or security amount is 10 percent or less), it is a governmental bond and the interest on the bond is tax exempt. If a bond “meets” these two tests (private use and repayment or security amount is over 10 percent), it is a private-activity bond and interest on the bond is taxable.

Is the interest on all private-activity bonds taxable?

No. The federal tax code provides certain exceptions that permit interest on bonds issued for certain “exempt facilities” to be tax-exempt even though the bonds “meet” the trade or business use and security interest tests. These facilities include airports, docks and wharves, mass commuting facilities, facilities for the furnishing of water, sewage disposal facilities, solid waste disposal facilities, facilities for the local furnishing of electricity or gas, local district heating or cooling facilities, certain hazardous waste disposal facilities, certain high-speed intercity rail facilities, and certain residential rental projects. Various conditions and limitations apply to the use of tax-exempt bonds for each of these exempt facilities.

The tax code contains an additional group of programs for which private-activity bonds may be issued on a tax-exempt basis, provided the programs are “qualified” by meeting specific conditions and limitations spelled out in the code for each of the programs. These are the mortgage revenue bond, veterans’ mortgage bond, small-issue industrial development bond, student loan bond, redevelopment bond, and §501(c)(3) not-for-profit organization bond programs.

Are bonds for governmentally owned and operated facilities classified as private-activity bonds?

Yes, some bonds issued to finance governmentally owned and operated facilities are categorized as private-activity bonds. They include bonds for governmentally owned airports, docks and wharves, and mass commuting facilities. The operation of the facilities usually utilizes leases, management contracts, and other arrangements with the private sector, resulting in more than 10 percent of the bond proceeds being used by a private business, and the payments from these businesses (such as airlines) are pledged to repay the bonds. These facilities are “exempt facilities” under the federal tax code.
Are governmental bonds and tax-exempt, private-activity bonds treated differently in the tax code?

Yes. Tax-exempt, private-activity bonds are subject to the following tax code provisions that do not apply to governmental bonds:

- **Statewide volume cap.** This is a ceiling on the aggregate amount of tax-exempt, private-activity bonds that may be issued in a state in any given year. The ceiling is the greater of $50 per capita or $150 million. These caps are scheduled to increase under current law. (See Appendix A.) Exceptions to the volume cap are exempt facility bonds for airports, docks and wharves, and government-owned solid waste facilities, as well as bonds for veterans’ mortgages, §501(c)(3) organizations, bonds for governmentally owned high-speed rail facilities, and 75 percent of bonds for privately owned high-speed rail facilities. All other tax-exempt, private-activity bond programs must compete with each other for volume cap allocations.

- **Alternative minimum tax (AMT).** Interest earned on tax-exempt private-activity bonds must be included in an individual’s calculation of the AMT. Corporations also must include such interest in their AMT calculation. While interest on governmental bonds is not taxed to the individual, corporations must include all tax-exempt bond interest in their adjusted current earnings (ACE), which is another so-called preference item that is included in the AMT calculation.

- **Limitations on advance refundings.** Since 1986, in general, tax-exempt, private-activity bonds may not be advance refunded, and governmental bonds may be advance refunded once. An advance refunding is the refunding of an outstanding issue of bonds prior to the date on which the bonds become due or are callable.

- **Other restrictions and requirements.** A number of other restrictions and requirements contained in the tax code apply to tax-exempt, private-activity bonds. They include: who may hold such bonds (no substantial user or related person), maturity of bond (may not exceed 120 percent of economic life of facility), restriction on use for land acquisition (no more than 25 percent of proceeds), a prohibition on use of proceeds to acquire existing property, public approval requirements, and a limitation on use of proceeds to pay bond issuance costs (no more than 2 percent). Mortgage revenue bonds, student loan bonds, and §501(c)(3) organization bonds are exempted from some of these requirements.

Who controls the issuance of municipal bonds?

State governments place controls on the use of tax-exempt financing, but mainly it is the federal government that regulates tax-exempt financing. The federal income tax code in §§141 through 150 specifies the rules for determining if a bond may be used on a tax-exempt basis and severely restricts the issuance procedures—and in some cases the volume—of debt sold annually in each state. Local government statutes or policies also affect debt issuance.
Does the U.S. Constitution prevent Congress from taxing the interest on tax-exempt municipal bonds?

No. On April 20, 1988, the U.S. Supreme Court ruled that the federal government may tax the interest paid on state and local bonds. The 7-to-1 decision in South Carolina v. Baker overturned an 1895 precedent in the Pollock v. Farmer’s Loan & Trust Co. case, which had been the foundation for the doctrine of intergovernmental tax immunity. That doctrine held that the federal government does not tax the states, and the states do not tax the federal government.

In deciding that the Constitution does not guarantee tax immunity for interest on state and local bonds, the Court declared that state and local governments “must find their protection from congressional regulation through the national political process.” Justice Sandra Day O’Connor issued a strong dissent, arguing “if Congress may tax the interest on state and local bonds it may strike at the very heart of state and local government activities....”

—Justice Sandra Day O’Connor

How did the 1988 Supreme Court ruling affect tax-exempt financing?

The decision had no immediate consequence on the status of outstanding tax-exempt bonds. However, it opened the door for increased restrictions by Congress. In the aftermath of the South Carolina decision, House Ways and Means Committee Chairman Dan Rostenkowski stated that the decision “merely reaffirmed the congressional position since 1968. In short,
Congress felt—and the Supreme Court has affirmed—that Congress has the power to impose reasonable restrictions on tax-exempt bonds. Case closed.”

**Do state and local governments tax interest earned on federal securities?**

No. State and local governments are prohibited by federal statute (31 U.S.C. §3124(a)) from taxing the interest earned on federal securities. This statute has its foundation in Article VI, Clause 2 (the “Supremacy Clause”) of the U.S. Constitution, which states that the laws of the United States shall be the supreme law of the land, the constitution or laws of any state to the contrary notwithstanding. The prohibition of §3124(a) extends not only to the borrowing of the U.S. Treasury Department and federal agencies for governmental purposes, but also to debt issued by government-sponsored enterprises such as the Federal Home Loan Banks, the Student Loan Marketing Association (Sallie Mae), and debt issued by the Resolution Trust Corporation to bail out failing savings and loan institutions.

**Do state and local governments tax interest earned on municipal bonds?**

State and local government taxation of interest earned on municipal bonds varies among the 50 states. Some states tax such interest on all municipal bonds, including their own and their localities’ bonds. Other states exempt interest earned on all municipal bonds regardless of who the issuer is. Many states exempt interest earned on their own and their localities’ bonds but subject interest earned on other states’ and localities’ bonds to income tax. The ability of a local government to tax interest earned on municipal bonds is subject to its own state’s laws and the way its income tax is structured.

**Why should Congress continue to support tax-exempt financing?**

Tax-exempt bonds are the mechanism through which state and local governments raise capital to finance a wide range of essential public projects. It is not in the national interest to let federal taxation reduce the financial power of state and local governments to meet their needs. In addition, changes in intergovernmental relations over the past several years have affected the ability of state and local governments to finance their needs. Their financing needs are increasing, not decreasing. Among the reasons for this increase are the drastic reduction or elimination
of federal assistance of various kinds, including categorical grants and general revenue sharing, and increasing federal mandates (legislative or regulatory requirements imposed by the federal government upon states and localities), particularly environmental mandates.

Another reason why Congress should continue to support tax-exempt financing is the national infrastructure crisis the nation faces. According to the Congressional Budget Office (CBO), total federal spending on infrastructure has dropped over the past two decades, from 1.06 percent of the gross national product (GNP) in 1977 to 0.57 percent in 1998.\(^1\) Total federal spending for infrastructure as a percentage of all federal spending has also declined significantly, from a 5.1 percent share to 2.84 percent. Since much of the cost of building and renovating the nation’s public infrastructure will be borne by state and local governments, continued use of tax-exempt financing will be vital if they are to meet these needs in an efficient and economic manner.

\(^1\)Trends in Public Infrastructure Spending. Congressional Budget Office. May 1999.
How has tax-exempt financing been affected by legislative changes?

Congress modified tax-exempt bond laws six times during the 1980s—in 1980, 1982, 1984, 1986, 1987, and 1989—with the 1986 Tax Reform Act containing the most substantial changes. It also made several bond law changes during the 1990s. A major objective of many of these legislative changes has been to reduce the benefits of tax exemption. Thus, many types of activities are no longer eligible for tax-exempt financing, while others are eligible but are subject to limitations such as the statewide volume caps. Other changes in the law limit the demand for tax-exempt bonds by removing incentives previously available to major purchasers. Finally, sound financial management has been made more difficult and expensive because of rules such as the arbitrage rebate requirement, the limitations on advance refundings, and the tests used to distinguish governmental and private-activity bonds. These provisions are discussed in greater detail in subsequent questions in this chapter. Also, Appendix A contains an outline summary of major legislation since 1968 relating to tax-exempt bonds.

What were the major forces pushing for changes to tax-exempt bond laws?

A reduction in the use of tax exemption to benefit private parties has been a major reason for limiting the use of tax-exempt financing. However, this also raises barriers to creation of public-private partnerships. Curtailment of abusive past practices—for example, issuing bonds solely to earn arbitrage from the investment of bond proceeds—also was a motivating factor. The strict arbitrage restrictions contained in the 1986 Tax Reform Act mitigated this concern. These restrictions included an arbitrage rebate requirement.

Another motivating factor has been a perceived need to reduce the volume of tax-exempt bond issuances. The tax-exempt bond market expanded dramatically during the 1970s and early 1980s, particularly bonds to finance private activities. According to the staff of the Joint Committee on Taxation, between 1975 and 1985, the volume of long-term, tax-exempt obligations for private activities (including tax-exempt IDBs, student loan bonds, mortgage
revenue bonds, and bonds for use by certain nonprofit charitable organizations) increased from $8.9 billion to $116.4 billion. Congress and the executive branch viewed this expansion as a misallocation of capital.

Finally, restrictions on tax-exempt financing were driven by mounting federal budget deficits. They forced Congress to look at every potential revenue source (including reductions in “tax expenditures” as tax exemption is characterized) in order to raise funds. As deficit reduction targets became more difficult to meet, the pressure to curtail tax-exempt financing grew stronger.

What has been the impact of these legislative changes?

Congressional changes to tax-exempt bond laws provided one desired result. According to testimony of David M. Thompson of The Bond Market Association before the U.S. House Committee on Ways and Means in March 1990, tax-exempt bond volume fell from a record level of $216 billion in 1985 to $102 billion in 1987. Volume has grown since then as state and local governments have issued new debt for infrastructure-related projects. In 1998, for example, long-term issuance totaled $285.9 billion. However, $81 billion of that total represented refinancings of outstanding debt as issuers took advantage of lower interest rates to achieve debt service savings.²

Another effect of the 1986 Tax Reform Act has been a significant shift in the demand for tax-exempt bonds. Before 1986, commercial banks were the biggest investors in tax-exempt bonds. Because the 1986 Act made it unprofitable for banks to buy most municipal bonds, the proportion of municipal bonds owned by banks has fallen dramatically. The result has been that the municipal bond market has become much more dependent on individual investors. This overdependence on a single market sector results in a more volatile market for state and local government issuers.

For issuers, changes to tax-exempt bond laws have made the issuance of bonds significantly more costly and more complex. The arbitrage rebate requirement,

²The Bond Buyer 1999 Yearbook.
for example, has increased issuance costs and represented a waste of financial and intellectual resources of state and local governments. In 1992, the Internal Revenue Service collected $290.99 million in arbitrage rebates from 1,761 bond issues. This is money that could have been spent on new infrastructure or to reduce the costs of the projects the bonds financed. Nor does the rebate figure include the millions state and local governments spend tracking expenditures and investments of bond proceeds, doing rebate calculations, and taking other steps to comply with the requirements.

Are changes needed to current tax-exempt bond laws?

Yes. If state and local governments are to meet their increased financing needs and bear their share of the costs of rebuilding the nation’s public infrastructure, current tax law restrictions on tax-exempt financing need to be eliminated or eased. These restrictions are not only burdensome and onerous, but they add to the costs of providing public facilities.

What changes are needed?

The final report of the Anthony Commission on Public Finance, entitled *Preserving the Federal-State-Local Partnership: The Role of Tax-Exempt Financing*, provides an excellent summary of recommended changes. Among the major proposals contained in that report and offered by others are: (1) changes in arbitrage restrictions; (2) restoration of the bank interest deduction; (3) repeal of the alternative minimum tax (AMT) on tax-exempt interest; (4) new rules distinguishing governmental bonds and private-activity bonds; (5) modifications to statewide volume caps; (6) authority for more advance refundings; and (7) reclassification of tax-exempt §501(c)(3) organization bonds as “public purpose” where bond proceeds provide facilities used exclusively in charitable activities for a public benefit. Ten years later, many of the changes recommended by the Anthony Commission have been actively supported in the Congress, but few have been enacted into law. The remainder of this chapter will explain in detail these recommended changes.
What is arbitrage?

Unspent municipal bond proceeds are often invested in higher-yielding securities until the monies are needed for the facilities being financed by the bonds. This is particularly true for bonds issued for infrastructure facilities that take months or even years to build. The earnings on these investments that exceed the municipal bond yield are called arbitrage. Current federal law limits the amount of arbitrage that can be earned and requires that arbitrage earnings be rebated to the federal government. This is an onerous requirement because it imposes complex bookkeeping and other compliance costs on issuers—even if a rebate is not owed—and because it prevents issuers from generating additional funds that could be used to reduce the costs of bond-financed projects.

What is the bank interest deduction?

Historically, banks have been major purchasers of municipal bonds. Prior to 1986, banks were permitted to deduct all or a major portion of the interest costs they incurred to invest in municipal bonds. The 1986 Tax Reform Act eliminated this deduction except for the bonds of certain very small issuers. An exception to the law permits banks to deduct 80 percent of the costs of purchasing and carrying bonds of issuers that do not issue more than $10 million of bonds annually. The $10 million figure has not been changed since 1986. The result has been a very substantial reduction in bank demand, down from $203.4 billion of municipals in bank portfolios in 1986 to $104.8 billion in 1998. Other tax law changes are also discouraging another historical group of investors—property and casualty insurance companies—from investing in municipal bonds. This has resulted in greater volatility and less liquidity in the municipal market and higher borrowing costs for issuers.

Why are banks and other corporations important purchasers of municipal bonds?

Stability in the municipal bond market is essential to its efficient operation. Restoration of the pre-1986 bank interest deduction level would restore bank demand and provide some stability by bringing this group of institutional investors back into the municipal bond mar-
ket. An added benefit for banks would be to provide an inducement for them to invest in less risky investments than those that have contributed to the financial difficulties of banking institutions. Benefits to communities, particularly smaller communities, would be investment by local banks in their own communities and the ability of issuers to sell bonds through private placements with banks, thus lowering their borrowing costs.

How does the federal government tax interest on tax-exempt bonds?

Interest on tax-exempt bonds is subject to the individual and corporate alternative minimum tax (AMT). These taxes were designed to ensure that taxpayers could not avoid paying income taxes entirely. The 1986 Tax Reform Act provisions subjecting tax-exempt interest to the AMT have contributed both to increased costs for issuers (bonds subject to the AMT pay roughly 25 more basis points in interest than bonds not subject to the AMT) and to a reduced demand for municipal bonds by some investors. Purchasers of municipal bonds already pay an indirect tax by earning a lower rate of return because of the tax-exempt status of the interest on the investments. Repeal of the AMT on municipal bonds would result in lower borrowing costs for issuers and help restore demand for those bonds by investors who fear they may be subject to the AMT. Also, municipal bonds are purchased with after-tax monies; they are not a tax shelter.

Why are new rules for categorizing bonds needed?

Bonds for certain governmental facilities are inappropriately categorized as private-activity bonds. This categorization impedes the financing of these projects because of the requirements and limitations that apply to private-activity bonds. It also inhibits financing of facilities for which appropriate private use could materially assist in the efficient provision of public services.

Changes should also be made to the present rules that arbitrarily limit the amount of private use of a facility (the 10 percent limit) without taking into account whether or not the facility is fulfilling a public purpose. Such changes would lead to more efficient and less costly provision of public-purpose facilities and permit more public-private partnerships in the building and operation of such facilities. Such changes could have a significant effect on the role of state and local governments in meeting the nation’s infrastructure needs.

What changes should be made to the statewide volume caps?

Current law imposes a unified volume cap restricting the dollar amount of bonds of particular types that can be issued annually in each state to the greater of $50 per capita or $150 million. These amounts were set in 1986 and will increase beginning in 2003. In addition, if the
private-use portion of a governmental bond exceeds $15 million, the excess over $15 million is subject to the volume cap even though the private-use portion of the bond does not exceed the 10 percent private use and security tests.

The administrative requirements of complying with the volume cap provisions are costly and burdensome to states. Recommended changes to the tax laws regarding the volume cap are: (1) remove the private-use portion of governmental bonds subject to the volume cap; (2) accelerate the increase in volume cap amounts to keep pace with increased costs of providing facilities and services eligible for tax-exempt financing; (3) eliminate certain bonds from the volume cap; and (4) index the volume cap for inflation.

What are advance refundings?

An advance refunding occurs when issuers refinance outstanding bonds before the original bonds mature or are callable. In effect, issuers sell new bonds to “retire” or buy back outstanding bonds. Borrowers advance refund their outstanding debt when long-term interest rates drop, thus reducing their borrowing costs and freeing up resources for new projects. Since 1986, in general, private-activity bonds may not be advance refunded, and governmental bonds may be advance refunded once. Periods of low interest rates in the 1990s have brought proposals for easing restrictions on advance refundings so state and local governments can lower the costs of their borrowing, just as many homeowners are reducing their mortgage payments.

What tax-law changes have been suggested for §501(c)(3) organization bonds?

Not-for-profit organizations engaged in charitable activities for public benefit and exempt from income taxation under §501(c)(3) of the Internal Revenue Code are permitted to issue tax-exempt bonds used exclusively for facilities that benefit the public. Examples are hospitals, nursing homes, and facilities for the elderly. Under the Tax Reform Act of 1986, tax-exempt bonds of §501(c)(3) organizations are treated as “private-activity bonds.” While they are exempt from some of the more onerous provisions affecting private-activity bonds, including the statewide volume cap, the prohibition against advance refundings and the alternative minimum tax, they are subject to other provisions that unnecessarily restrict the use of bond proceeds to finance facilities that would otherwise have to be provided by governmental entities.

The 1986 Act placed a further restriction on tax-exempt bonds for facilities other than hospitals. While not subject to the statewide volume caps, §501(c)(3) organizations could not have more than $150 million of “non-hospital bonds” outstanding at any one time. Such limitations discriminated against multi-facility health organizations and failed to recognize the increasing importance of health care provided in other than acute-care hospital beds. However, this provision was repealed in 1997 (see Appendix A).
Mindful of continuing federal budget pressures, how can the tax exemption for state and local government bonds be justified?

Of course, the costs of achieving and maintaining a balanced budget must be borne by all taxpayers. Removal of tax exemption for state and local government bonds, however, would significantly increase the costs of providing public facilities, particularly infrastructure facilities, most of which are built, maintained, and operated by state and local governments and financed with tax-exempt bonds. Loss of tax exemption would unfairly push those costs on to state and local taxpayers who are, after all, federal taxpayers as well.

No member of Congress or the executive branch has called for elimination of tax-exempt financing by state and local governments. Debate has focused instead on appropriate uses for tax-exempt financing. The tax code provisions for which changes are proposed in the preceding chapter were enacted primarily to eliminate the use of tax-exempt financing for the benefit of private interests and curb practices deemed abusive.

Isn’t tax-exempt financing just another subsidy for a special interest?

State and local governments are not a “special interest group.” The bonds of state and local governments are tax-exempt because they finance facilities vested with a public interest that are designed to serve the needs of the entire community rather than a narrowly defined private interest.

Municipal bonds are also tax-exempt because of the historical and traditional reciprocal tax immunity between the federal government and the state and local levels of government. Despite the fact that the Supreme Court has declared that immunity of state and local government bond interest from federal taxation is not constitutionally protected, it is sound public policy to keep the cost of providing public facilities as low as possible. The ability to sell debt with interest exempt from federal income taxes reduces the interest for borrowed funds
by approximately 25 percent. This system has worked well for over 100 years and has benefited all the nation’s taxpayers.

Are tax-exempt bonds an inefficient subsidy?

Decisions about the provision of public facilities and services are best and most efficiently made at the state and local levels.

In 1976 President Carter proposed a direct federal subsidy to state and local finance that was known as the “taxable bond option.” Under this proposal, state and local government bonds would be issued as taxable bonds and a federal subsidy would be paid to the issuer to make up the difference in interest rate. The proposal was widely criticized and was rejected by Congress. In speaking against the proposal, Rep. Dan Rostenkowski (D-IL), a member of the House Ways and Means Committee, warned that “cities that lose control of their finances lose control of their destiny.”

Who owns municipal bonds?

The largest proportion of state and local government debt is held by individuals, as household, mutual fund, or money market fund investors. At the end of 1998 these individuals held 72 percent of the outstanding debt. They have diverse economic backgrounds. According to the Treasury Department’s 1995 income tax data, a large portion (89.3 percent) of individuals reporting tax-exempt interest income had adjusted gross incomes (AGIs) under $200,000, and of that number, about three-fourths (73.4 percent) had AGIs under $100,000.3

As would be expected, and consistent with trends in holdings of other financial assets, individuals in higher income brackets (AGIs over $100,000) reported a significantly larger portion of tax-exempt interest than did individuals in lower income brackets. However, among all returns reporting tax-exempt interest, 63 percent of taxpayers had AGIs under $75,000.

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How Do Municipalities Disclose Information About Bonds?

In keeping with principles of federalism that preserve state and local financial authority, municipal securities issued by state and local governments are exempt from the Securities and Exchange Commission’s (SEC) registration and reporting requirements that apply to corporations. However, the antifraud provisions of the federal securities laws apply. Any person, including a municipal issuer, who makes false or misleading statements of material fact or omits any material fact that causes such statements to be misleading violates federal law.

To ensure that existing and potential bondholders have relevant financial and operating information about state and local governments that are issuing municipal bonds, state and local government issuers provide or disclose information about their bonds and/or about their governmental functions before, during, and after issuing municipal securities. Since certain municipal bonds are exchanged between buyers and sellers in the secondary market after a primary issuance (bond sale) has been completed, continuing disclosure information remains necessary for decisions being considered by investors in the municipal market.

Rule 15c2-12 is the SEC regulation that provides guidance to issuers, underwriters, and potential investors on disclosing information to the municipal market. The rule, first issued in 1989, was amended in 1994, and was accompanied by interpretive guidance from the SEC on disclosure responsibilities.

The amended rule requires broker-dealers who underwrite municipal bonds to determine that the issuer has agreed in writing to provide annual financial information and disclose any material event before underwriting a bond of $1 million or more. Certain small governments are exempt from the requirements. The information is sent to central clearinghouses, known as nationally recognized municipal securities information repositories (NRMSIRs), and to a state’s information depository, if one exists. A change in a bond rating is one example of a material event.

In addition to Rule 15c2-12 and provisions of other federal statutes, there are state laws imposing requirements for municipal securities. All of these regulations ensure that information about state and local government issuers is available to investors in the primary and secondary markets.
Over the past several years, Congress has made a number of changes to tax-exempt bond laws. The following summary outlines some of the major provisions of federal tax law since 1968 as they relate to tax-exempt financing.

**Revenue and Expenditure Control Act of 1968 (Public Law 90-364)**

This legislation established that the interest income from industrial development bonds (IDBs) is taxable, and defined IDBs according to a two-part test. Any bond that met a private use test and a security interest test was defined as taxable.

The private use test was satisfied if all or a major portion of the bond proceeds were to be used in a trade or business of a non-exempt person (that is, neither a government unit nor a charitable §501(c)(3) organization). The security interest test was satisfied if all or a major portion of the debt service was to be secured by property used in or payments derived from a trade or business of a non-exempt person. The threshold level for both tests was set at 25 percent. (Later, as part of the 1986 Tax Reform Act, the allowable private use was reduced to 10 percent or, for public power, the lesser of 10 percent or $15 million.)

The 1968 legislation also provided a long list of exceptions, termed “exempt purpose IDBs,” for projects that were deemed to serve a worthwhile public purpose and thus should be eligible for tax exemption. Such exceptions included:

- air and water pollution control facilities;
- sewage or solid waste disposal facilities;
- facilities for local furnishing of electric energy, gas or water; and
- airports, docks, and wharves.

This legislation also restricted the use of IDBs to small issues of not more than $1 million, which was raised to $5 million in subsequent legislation.
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<th><strong>Tax Reform Act of 1969 (Public Law 91-172)</strong></th>
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<td>This legislation denied the tax exemption for any municipal bond issuance defined as an “arbitrage bond.” An <em>arbitrage bond</em> is an issuance in which all or a major portion (subsequently defined as 85 percent) of the proceeds are used directly or indirectly to purchase securities producing a materially higher yield. Exceptions were provided for temporarily investing the proceeds (with “temporary period” later defined as three years) and for a reasonably required reserve or replacement fund.</td>
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<th><strong>Revenue Adjustment Act of 1975 (Public Law 94-164)</strong></th>
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<td>A new exception was added by this law to the list of exempt-purpose IDBs, allowing tax-exempt financing for dams furnishing water for irrigation with a subordinate use for generating electricity. The exception was allowed only if substantially all stored water was available for release for irrigation purposes.</td>
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<th><strong>Tax Reform Act of 1976 (Public Law 94-455)</strong></th>
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<td>This law added a new tax-exempt purpose: qualified scholarship funding bonds.</td>
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<th><strong>Revenue Act of 1978 (Public Law 95-600)</strong></th>
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<td>This Act further liberalized eligibility for tax exemption by allowing more private projects to qualify under “local furnishing” of electricity. It also increased the limits on small-issue IDBs from $5 million to $10 million.</td>
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<th><strong>Crude Oil Windfall Profits Tax of 1980 (Public Law 96-223)</strong></th>
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<td>Electricity-generating or alcohol-producing solid waste disposal facilities were made eligible for tax-exempt financing by this Act, and hydroelectric and other renewable energy generating facilities were also added to the list of eligible facilities.</td>
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<th><strong>Mortgage Subsidy Bond Tax Act of 1980 (Public Law 96-499)</strong></th>
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<td>This legislation eliminated tax-exempt mortgage bonds as of January 1, 1984 (later extended), and also made such bonds subject to an annual state volume cap (the first time such a limitation was imposed) and to arbitrage and advance refunding restrictions.</td>
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<td>This law added certain mass-commuting vehicles and certain volunteer fire departments to the list of eligible facilities, and provided a safe harbor for the leasing of mass-commuting vehicles.</td>
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Tax Equity and Fiscal Responsibility Act of 1982 (Public Law 97-248)

In a provision that was unsuccessfully challenged in *South Carolina v. Baker*, this Act required that bonds be issued in registered form in order to remain tax exempt. The Act also imposed an information reporting requirement on certain types of bonds called “private-activity bonds,” including IDBs, student loan bonds, and §501(c)(3) bonds. The law also added local district heating and cooling facilities to the list of eligible purposes, and set a sunset date of December 31, 1987, for the small-issue IDB program. In addition, the legislation reduced the interest deduction for financial institutions from 100 percent to 85 percent of the costs to purchase and carry tax-exempt obligations.

Social Security Amendments of 1983 (Public Law 98-21)

This Act required Social Security recipients to include interest earned on tax-exempt bonds in gross income for purposes of determining the taxation of Social Security benefits.

Deficit Reduction Act of 1984 (Public Law 98-369)

This Act imposed a statewide volume cap on private-activity bonds of the greater of $150 per capita (reduced to $100 after 1986) or $200 million. There were exceptions for certain “qualified public facilities,” including multifamily housing and publicly owned airports, docks, wharves, mass-commuting facilities, and convention or trade show facilities, but the Act repealed authority for advance refunding for qualified public facilities. The Act also eliminated the tax exemption of interest on bonds in cases where more than five percent of the proceeds of such bonds were to benefit a non-exempt purpose. Tax exemption was also denied for bonds issued to finance “sky boxes” in sports arenas, airplanes, health club facilities, gambling facilities, or liquor stores. Additional restrictions were placed on veterans’ mortgage bonds, and the bank deduction of the costs of purchasing and carrying tax-exempt bonds was lowered from 85 to 80 percent. The Act also restricted tax-exempt entity leasing and arbitrage earnings for student loan bonds, made changes to the small-issue IDB program, and extended the sunset date of the program through 1988 for manufacturing facilities.

Tax Reform Act of 1986 (Public Law 99-514)

The Tax Reform Act of 1986 rewrote the Internal Revenue Code of 1954, resulting in the following changes to tax-exempt bond law:

- Defined “private-activity bonds” to include IDBs as well as student loan bonds, mortgage revenue bonds, and §501(c)(3) organization bonds;

- Subjected income of individuals and corporations that is preferentially treated under the tax code, including income from private-activity bonds issued after August 7, 1986 (excluding §501(c)(3) organization bonds), to an alternative minimum tax (AMT), resulting in a new class of bonds that may be only partially tax exempt. Also subjected all tax-exempt interest earned by corporations to the AMT under the adjusted net book
income calculation (changed in 1989 to the adjusted current earnings (ACE) calculation);

- Required rebate of “excess” arbitrage earnings to the federal government, with exemption for small issuers (governmental units with taxing authority that issue less than $5 million of bonds annually) or if proceeds are spent within six months of issuance;

- Added hazardous waste disposal facilities as a new category of exempt-facility bonds;

- Denied tax-exempt status to private-activity bonds for sports facilities, convention or trade show facilities, parking facilities (unless functionally related to other exempt facilities), air or water pollution control facilities, alcohol and steam generation facilities, qualified hydroelectric generating facilities, and privately owned airports, docks, wharves, and mass-commuting facilities;

- Prohibited advance refunding for private-activity bonds (§501(c)(3) organization bonds excepted), and limited governmental obligations issued after 1985 to one advance refunding;

- Lowered the private use and security interest tests from 25 percent to 10 percent, and added a special private use restriction on “output facilities” (for generation, transmission, and distribution of electricity or gas) of the lesser of 10 percent or $15 million;

- Imposed a limit of the lesser of 5 percent or $5 million on loans to nongovernmental persons or for private business purposes unrelated to the governmental use of the financing;

- Limited bond issuance costs for private-activity bonds to 2 percent of proceeds;

- Reduced the statewide volume cap on private-activity bonds to the greater of $50 per capita or $150 million effective in 1988, and subjected the excess over $15 million of private use portion of governmental bonds to the volume cap;

- Required all individual income tax returns filed after December 31, 1987, to report tax-exempt interest income;

- Repealed the bank interest deduction for costs of purchasing and carrying tax-exempt bonds except for issuances of governmental units and §501(c)(3) organizations that issue less than $10 million of bonds annually;

- Required property and casualty insurance companies to reduce deductions for loss reserves by 15 percent of the company’s tax-exempt interest income from bonds acquired after August 7, 1986.
Superfund Amendments and Reauthorization Act of 1986 (Public Law 99-571)

This Act increased the corporate alternative minimum tax (AMT) on all tax-exempt interest income.

Omnibus Budget Reconciliation Act of 1987 (Public Law 100-203)

This legislation defined bonds used by cities to acquire nongovernmental gas and electric utility output property as “private activity” bonds if the city does not already operate a municipal utility. Exceptions were allowed for qualified annexations no greater than 10 percent (per annexation) of the geographic service area or output capacity of the public power system.

Technical and Miscellaneous Revenue Act of 1988 (Public Law 100-647)

This Act made a number of technical changes to the arbitrage rebate requirement and other tax-exempt bond provisions of the tax law, and extended the mortgage revenue bond program one year, through December 31, 1989, with tighter targeting provisions. It also authorized the use of tax-exempt, private-activity bonds for certain high speed rail facilities and required that only 25 percent of the financing would be subject to the statewide volume cap. A new savings program was instituted under this Act that permitted taxpayers below a certain income level to exclude from taxable income interest income on U.S. savings bonds (Series EE Bonds) if the bonds are used to help pay education expenses of the taxpayers, their spouses, or their children. These bonds carry a superior yield and compete with the market for state and local government bonds.

Omnibus Budget Reconciliation Act of 1989 (Public Law 101-239)

This Act contained changes to the arbitrage rebate requirement, use of hedge bonds, and the alternative minimum tax (AMT).

Specifically, relief from the arbitrage rebate requirement was provided for issuers of governmental bonds, qualified §501(c)(3) bonds, and private-activity bonds for governmentally owned facilities if at least 75 percent of net proceeds are to be used for construction and 95 percent of the funds are spent according to a spending schedule over a 24-month period. Issuers using this rebate relief provision may elect a financial penalty in lieu of rebate if the spending schedule is not met.

In addition, new requirements were imposed on the ability of state and local governments to sell bonds as a hedge against future increases in interest rates (so-called “hedge bonds”). The Act also provided that 75 percent of bonds issued to finance high speed intercity rail facilities (but not rolling stock) would not be subject to the statewide volume cap. Finally, the mortgage revenue bond and small-issue IDB programs were extended for nine months.

Omnibus Budget Reconciliation Act of 1990 (Public Law 101-508)

This Act extended the mortgage revenue bond and small-issue IDB programs through December 31, 1991.
Tax Extension Act of 1991 (Public Law 102-227)

This Act extended the mortgage revenue bond and small-issue IDB programs for six months, through June 30, 1992.


This Act contained three provisions that affect tax-exempt financing.

The Act removed restrictions on investments of nuclear decommissioning funds (previously restricted to U.S. Treasury securities, bank deposits, and tax-exempt state and local government securities) and lowered the funds’ 34 percent tax rate to 22 percent in 1994 and 20 percent in 1996. The removal of restrictions on investments also removed an incentive for the funds to purchase state and local government bonds.

Tax-exempt financing is permitted for local furnishing of electricity, previously limited to certain contiguous areas, to facilities that have been ordered by the Federal Energy Regulatory Commission to provide transmission (“wheeling”) services to other parties that generate electricity without violating the Internal Revenue Code’s local furnishing exception if no tax-exempt bond financing is provided for the non-local furnishing activities.

The Act also authorized a new type of exempt-facility bond for environmental enhancement of hydroelectric generation facilities that is not subject to the statewide volume cap, provided 80 percent of the net proceeds of each bond is used to finance property for the promotion of fisheries or other wildlife resources.

Omnibus Budget Reconciliation Act of 1993 (Public Law 103-66)

This law contained several provisions that affect tax-exempt financing and the market for tax-exempt bonds.

It extended the mortgage revenue and small-issue industrial development bond programs permanently, retroactive to June 30, 1992, when they expired.

It authorized the designation of nine empowerment zones and 95 enterprise communities in economically distressed urban and rural areas. A new category of exempt-facility bonds could be used in the zones and enterprise communities to buy land, buildings, and equipment.

It extended the exemption from volume cap allocation to 100 percent of bonds for governmentally owned high speed intercity rail facilities (not including rolling stock).

This law also changed market discount rules so that market discount earned on tax-exempt bonds purchased after April 30, 1993, would be treated as ordinary income rather than capital gain as under previous law. Since ordinary income tax rates for many investors are higher than the capital gains rate, this change could have a negative impact on the demand for state and local government bonds.
Unfunded Mandates Reform Act of 1995 (Public Law 104-4)

The Act affects Congressional Budget Office cost estimates on bills impacting state and local government expenditures and revenue authority. Establishes a point of order against any reported bill estimated to cost state and local governments more than $50 million (adjusted for inflation) per year for new mandate proposals that are not fully funded. Mandates are defined as enforceable duties imposing direct costs on state and local governments. Direct costs also include amounts state and local governments would be prohibited from raising in revenues.

Small Business Jobs Protection Act of 1996 (Public Law 104-188)

This legislation included three tax-exempt bond provisions.

It made modifications to rules governing the issuance of tax-exempt bonds for first-time farmers; it modified the “two-county” bond rule for local furnishers of electricity and gas; and it authorized tax-exempt bonds for the purchase of the Alaska Power Authority.

The Taxpayer Relief Act of 1997 (Public Law 105-34)

This law included several provisions in the area of tax-exempt bonds.

It increases the small issuer arbitrage rebate exception from $5 to $10 million for qualified education facilities allowing up to $5 million of additional bonds used to finance public school capital expenditures to be issued on a tax-exempt basis, after December 1, 1997. It waives certain mortgage revenue bond requirements and limitations in certain Presidentially declared disaster areas for bonds issued after December 31, 1996, and before January 1, 1999. It repeals the $150 million cap on nonhospital K501(c)3 bonds for new money issues.

It includes a package of simplification changes related to the $100,000 arbitrage rebate limitation, debate on debt service funds, limitations on certain nonpurpose investments, and repeal of expired provisions, effective after August 5, 1997.

Omnibus Appropriations Act of 1998 (Public Law 105-277)

This law included the first increase in private-activity bond volume caps since the 1986 Tax Reform Act. The current (1999) volume cap of $50 per capita or $150 million, whichever is greater, will be increased to the greater of $55 per capita or $165 million beginning in fiscal year 2003. The volume cap will then increase each fiscal year by $5 per capita or $15 million until fiscal year 2007, when it will reach maximum level of $75 per capita or $225 million, whichever is greater. The volume cap will not be indexed for inflation thereafter.
Appendix B

Who’s Who in the Public Finance Network

The Public Finance Network is a coalition of 46 organizations with an interest in tax-exempt bonds. It was formed in 1988 and works to preserve the tax-exempt status of state and local government bonds. The Network identifies national policies that support local and state governments’ ability to finance public needs in the public interest and informs policymakers about legislative and regulatory proposals that make it more difficult and more expensive for state and local governments to use tax-exempt bonds. The Network works to heighten public and congressional awareness about public financing.

Information about the Network and financing issues is available by calling any of the individuals listed below.

Airports Council International–North America .................. Jeff Goodell, 202/861-8089
American Association of Port Authorities .................. Elana Foster Kriess, 703/684-5700
American Association of School Administrators ........ Bruce Hunter, 703/875-0738
American Association of State Colleges and Universities .... Hillary Goldman, 202/293-7070
American Planning Association .................. Jeffrey Soule, 202/872-0611
American Public Gas Association .................. Robert Cave, 703/352-3890
American Public Power Association .................. Lori Pickford, 202/467-2954
American Public Transit Association .................. Art Guzzetti, 202/898-4000
American Public Works Association .................. Ann McCulloch, 202/393-2792
American Society for Public Administration ........ Mary Hamilton, 202/393-7878
Association of Local Housing Finance Agencies ........ John Murphy, 202/857-1197
Association of Metropolitan Sewerage Agencies ........ Ken Kirk, 202/833-2672
Association of Metropolitan Water Agencies ........ Diane Van De Hei, 202/331-2820
Association of School Business Officials International ...... Don Tharpe, 703/478-0405
Council of Development Finance Agencies ........ Aaron Mindel, 202/857-1162
Council of Infrastructure Financing Authorities ........ Al Alm, 202/371-9770
Council of State Community Development Agencies ........ John Sidor, 202/624-3630
Council of State Governments .................. Jim Brown, 202/624-5460
Education Finance Council  Harrison Wadsworth, 202/466-8621
Government Finance Officers Association  Bert Waisanen, 202/429-2750
International Bridge, Tunnel and Turnpike Association  Neil Gray, 202/659-4620
International City/County Management Association  Mike Lawson, 202/962-3634
International Institute of Municipal Clerks  Morris Bichess, 909/592-4462
International Municipal Lawyers Association  Henry Underhill, 202/466-5424
Municipal Treasurers’ Association  Stacey Crane, 202/737-0660
National Association of Counties  Ralph Tabor, 202/942-4254
National Association of County Treasurers
and Finance Officers  Marilyn Green, 303/660-7415
National Association of Development Organizations  Bill Amt, 202/624-7806
National Association of Elementary School Principals  Sally McConnell, 703/684-3345
National Association of Higher Educational
Facilities Authorities  Charles Samuels/Ed Fox, 202/434-7300
National Association of Housing and
Redevelopment Officials  Michael Nail, 202/289-3500
National Association of Independent Colleges
and Universities  Karen Johns, 202/785-8866
National Association of Regional Councils  Janet Oakley, 202/457-0710
National Association of State Auditors, Comptrollers
and Treasurers  Cornelia Schneider, 202/624-5451
National Association of State Budget Officers  Stacy Mazer, 202/624-5382
National Association of State Treasurers  Chris Allen, 202/624-8595
National Association of State Universities and Land Grant Colleges/
Association of American Universities  Jerry Roschwalb, 202/778-0855
National Association of Towns and Townships  Tom Halicki, 202/624-3550
National Conference of State Legislatures  Gerri Madrid, 202/624-8670
National Council of Health Facilities
Finance Authorities  Charles Samuels/Ed Fox, 202/434-7300
National Council of State Housing Agencies  Stockton Williams, 202/624-7710
National League of Cities  Cameron Whitman, 202/626-3000
National School Boards Association  703/838-6782
Public Housing Authorities Directors Association  Susan Juroe, 202/955-3000
U.S. Conference of Mayors  Larry Jones, 202/293-7330
Water Environment Federation  Jim Sullivan, 703/684-2416