The Economic Dangers

Of Deferring

State Tax Credits

James R. Moody & Associates

May 2010

Introduction

State governments are experiencing the second or third years of negative revenue growth due to the economic downturn. Many states have seen double digit drops in state revenue. Desperate times call for desperate measures, and some states are resorting to very short term fixes for what are both short term and very long term problems.

One proposal being discussed in a number of states, including Hawaii and New York, would defer the ability of holders of state tax credits from redeeming those tax credits for up to two or three years.

The purpose of this paper is to discuss the unintended consequences that will impact state governments that attempt to defer tax credits that have been authorized and issued by the states, and which are subject to redemption.

Background

In New York State, Governor David Patterson has proposed deferring the ability of holders of state tax credits from 29 specific tax credit programs from redeeming those tax credits in calendar (and tax) years 2010, 2011 and 2012. Patterson estimates that this deferral would save $100 million in 2010-2011, and $650 million in 2011-2012.

The Basics of Municipal Finance

The act of a government to engage in transactions related to governmental borrowing is generally referred to as municipal finance, whether it occurs at the state government level or the local government level. At its most basic level, a government will typically approach the financial credit markets to finance an infrastructure project, such as a state building or a prison, and ask to borrow money for the project with repayment of the borrowed principal with interest scheduled over a 20 to 25 year period. The borrowing is normally a bond issue that is sold into the financial market. Most governmental bonds are tax-exempt based upon federal law.

The preferred form of governmental borrowing is the so-called general obligation bond. In this approach, the borrower (the government) will ask its voters to approve the issuance of general obligation bonds to finance these projects. General obligations are a promise approved by the voters to enact or pledge whatever taxes are necessary to repay the bonds. General obligations normally receive the most favorable interest rate, due to the strong pledge of repayment by the government borrower and its citizens.

The other form of borrowing is called revenue bonds, which are not a general obligation, but would normally be repaid by a pledge of a specific ear-marked revenue source, such as a sales tax, a motor fuel tax, or a motor vehicle sales tax, or by a general pledge by the governmental entity to appropriate the public funds to repay the bonds. Revenue bonds are normally issued at a higher interest rate than general obligation bonds, since the pledge to repay is not as strong as a voter approved general obligation.

Purchasers of municipal bonds typically rely on the rating of one of the three major bond rating firms to determine the credit worthiness of municipal bond issuers. The range of municipal debt would be from the strongest credits (AAA rated general obligation debt) with the lowest interest rates; to less credit worthy borrowers with barely investment grade rated BBB debt, which would carry a much higher interest rate. The rating is an evaluation of the ability and willingness of the governmental bond issuer to repay.

For state governments, one of the easier measures of their ability to manage their finances is their bond rating. An AAA rated state would normally be considered the state with the greatest likelihood of repaying their debt.

Municipal Bond Investors

Municipal bonds are considered fixed income investments. When purchasing a municipal bond, an investor will know that if they hold the bond to maturity, they will typically receive a set rate of interest per year, and they will also know the exact schedule when their principal will be repaid to them.

Municipal bond investors want two things in their investments: **timeliness of interest payment and timeliness and certainty of principal repayment**. Municipal bond investors do not want to put their principal at risk, and they want to be certain that their original principal is repaid with the promised interest on the promised schedule.

Major purchasers of municipal bonds include large insurance companies, and major national, regional and local banks, which like the tax-exempt yield on municipal bonds and the normal certainty and timeliness of repayment of municipal debt.

Tax Credits As State Obligations

What, you may ask, does this discussion of municipal finance have to do with the issue of deferring state tax credits?? Well **the answer is a lot!!**

State tax credits are typically a promise that is contained in either a contract executed by a governmental entity or the issuance of a tax credit certificate by the governmental entity that enables the holder of the state tax credit to reduce a future tax obligation.

State tax credits are primarily an innovation in state finance of the past thirty years, and have primarily been utilized by states as economic development tools. Instead of issuing debt (such as municipal bonds) for these projects, or directly appropriating the funds to these projects, the state issues a tax credit to the investor. In many instances, the theory is that the increased tax revenue from the economic development project will come to the state at the same time the tax credit obligation comes due for redemption, thereby providing the increased public funds to meet the tax credit obligation.

For an investment in a specific economic development project, or in a fund that would finance a series of economic development projects, the state would promise the investor a tax credit against future state tax obligations. Some state tax credits would be issued only for a single year; others would be issued for a series of consecutive years, for example each year for a five year period or a ten year period.

Purchasers Of State Tax Credits

Most of the state tax credits that are issued by a state are eventually purchased by a third party. This is necessary because the entity doing the economic development project requires the capital to complete the economic development project, and they sell the tax credits as a way to raise the required capital. Typically the tax credits will provide a portion of the equity investment, and there will be conventional financing (such as a bank loan) to complete the non-equity portion of the transaction.

What do the purchasers of tax credits desire in their investment? They desire the same thing as purchasers of municipal bonds: **timeliness of interest payment and timeliness and certainty of principal repayment**. In many instances, the purchasers of tax credits are **the same purchasers as purchasers of municipal bonds.** They are major insurance companies and major banks and regional and local banks.

When determining whether to invest in state tax credits, they would be doing a similar analysis as when they purchase municipal bonds. They would determine what is the likelihood of the obligation (the state tax credit) being redeemed in a timely and certain manner as described in the purchase contract.

Certainty and Timeliness

Since the purchase of tax credits is in effect a credit transaction, any delay in payment inherently makes the transaction worth less. For example, in a municipal finance bond deal, if Insurance Company A loans a state governmental entity $1 million at a 5% interest rate to be repaid in a year with interest, Insurance Company A will expect to receive $1,050,000 repayment in a year. They would have analyzed their ability to receive repayment prior to purchasing the bond.

Similarly, if Insurance Company A was going to purchase a $1 million tax credit issued by the same state, they would do the same analysis prior to making the investment. Although one is a bond and the other is a tax credit, they are both obligations of the state and the financial analysis is the same.

The issue in these credit transactions is always the same: what is the timeliness and certainty or repayment. Only a fool would invest their money when there is uncertainty of timeliness and repayment of principal.

Bonds versus Tax Credits and Defaults

The technical term for the failure of a governmental entity to repay their bond obligations is a default. A default on debt is normally the end for the ability of a governmental entity to issue debt. If they are unable to meet the payment of their current debt obligations, the financial community would not extend them further credit in the future by purchasing their future bonds.

Since tax credits for the most part are not financial instruments that are rated by the three major bond rating industries, many in governmental circles would not consider deferring the ability to redeem tax credits to be a governmental default. (Note: in some instances tax credits have been bundled and securitized into bond issuances that have been rated by at least one of the three major bond rating agencies.) Technically it may be correct that deferring the redemption of state tax credits is not a default.

However, the deferral of tax credits will be considered an act of default by the people that are the major purchasers of both municipal bonds and tax credits: insurers and bankers. This is particularly true of tax credits that have not only been authorized, <u>but for which all actions to earn and vest the tax credits have been completed.</u>

For those tax credits that are part of a bond transaction that has been rated by one of the major bond rating agencies, the rating agency will ultimately determine whether a deferral of the credit impacts the state's credit rating. However, such a deferral would clearly cause a great concern from investors that purchased this rated security, which suddenly has the credit which is the basis for the security deferred and thereby rendered less valuable.

In many instances, the insurers and the banks not only purchase the tax credits, but will also provide the construction loans that allow these economic development projects to be completed. The deferral of tax credits may place both their tax credit investment and their loan at risk. They will consider their loss of ability to redeem these instruments issued by the state that defers the redemption of a tax credit as an act of default, whether or not a bond rating agency technically makes a decision that it is a default of a state obligation.

The Impact On States That Defer Tax Credits

The financial impact on states that defer the redemption of tax credits is fairly straightforward. The markets for any future tax credits will dry up, due to the uncertainty of redemption and the lack of timeliness of redemption. Investors will either refuse to purchase these tax credits or will pay dramatically less for them.

Remember that the major purchasers of these tax credits are also the major purchasers of municipal bonds. The same reaction will occur in the municipal bond markets. If a state is perceived to have "technically" defaulted on one financial obligation, the negative reaction to that technical default will spill over into their other financial transactions, which will impact their ability to issue debt and have it purchased at the most favorable rate.

When potential purchasers are eliminated from the market due to credit worthiness concerns, the price of borrowing will go up. This phenomenon will occur not only at the state government level, but will also filter down to municipalities, counties, and school districts that are municipal borrowers within the state.

Conclusion

States are facing enormous financial hurdles in balancing their budgets. There is great pressure to find quick fixes, but the consequences of a quick fix can in the long term mean financial disaster. States need to reject the push to defer the redemption of authorized and issued tax credits, as that practice will undermine the state's ability to finance future projects either through the issuance of municipal bonds or the issuance of tax credits.

<u>**James R. Moody**</u>

James R. Moody & Associates is a Jefferson City, Missouri based governmental relations and consulting firm. James R. (Jim) Moody is the president of the firm. Moody is the former Commissioner of Administration for the State of Missouri, where he served as the state's chief administrative official from 1989 through 1992. Moody is also a former Missouri state budget director.

Moody has also served as Executive Deputy Director of the Missouri Department of Social Services, Director of the Missouri Division of Family Services, and Assistant Director of the Ellis Fischel State Cancer Center.

From 1989 through 1992, Moody served as a member of the Governmental Accounting Standards Advisory Council, which served in an advisory capacity to the Governmental Accounting Standards Board. Moody is a former trustee of the Missouri State Employees Retirement System, the former chairman of the Missouri Public Entity for Risk Management, and a former member of the Missouri Board of Fund Commissioners.

In 1985, Moody was recognized as Public Administrator of the Year by the Missouri Institute of Public Administration. In 1994, Moody was named the Communicator of the Year by the Mid-Missouri Public Relations Society.

Moody received a bachelors degree in English Literature from the University of Notre Dame, and a masters degree in Public Policy from the University of Missouri-Columbia. Moody is also a graduate of Harvard University, John F. Kennedy School of Government, Program for Senior Executives in State and Local Government, and was a Danforth fellow while attending Harvard.