The Impact of Allegheny County's Bond Rating on Borrowing Costs

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Key Findings

- At present, Allegheny County has a total outstanding general obligation debt of about $564 million, well below its legal general obligation debt limit of over $2 billion. (p. 4)

- As a rule of thumb, analysts feel that a fund balance should be equal to at least 5% of the annual budget. Using this rule, the county's $515 million budget would require about $26 million in reserve. Current estimates are that the county's general fund balance will be about $37 million, leaving $11 million available to fund tax cuts while maintaining the desired five percent balance. (p. 5)

- Allegheny County is planning to issue about $90 million in new general obligation debt in 1996. If the County's AA rating holds, the total cost of the insurance would be $240,996, or $20,166 per year (discounted at 5.50%). (p. 7)

- Assuming, albeit implausibly, that the County's bond rating falls to the City of Pittsburgh's level (BBB+), the cost of bond insurance on the $90 million would be $352,457 or $29,494 per year—an increase of only $9328 per year, or less than an additional penny per year per county resident. (p. 7)

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INTRODUCTION

The purpose of this analysis is to explore the consequences of spending Allegheny County's surplus funds in order to help finance a reduction in County taxes. The analysis begins with a brief background discussion on municipal bonds and the municipal bond market. It then moves to a discussion of the factors that are used to determine bond ratings, which are an important influence on the interest rates that a governmental unit must pay. The analysis then ends with a conclusion which is, in essence, an attempt to provide an informed opinion as to the consequences of such a plan.

BACKGROUND

The Reason For Debt Finance

Municipal bonds are debt instruments (IOUs) issued by states, local governments, or agencies of either (water authorities, school districts, etc.). Short-term bonds are issued to smooth the cash flow between when bills come due and when taxes are collected, and long-term bonds are issued to finance public capital projects. The present analysis concentrates on long-term bonds.

THE RATIONALE FOR FINANCING CAPITAL PROJECTS WITH BONDS INSTEAD OF TAX REVENUES INVOLVES A PRINCIPLE OF FAIRNESS TO CURRENT AND FUTURE RESIDENTS OF THE AREA.

The rationale for financing capital projects with bonds instead of tax revenues involves a principle of fairness to current and future residents of the area. Suppose a local government wishes to build a $100 million convention center that will have a useful life of thirty years, and it decides to pay for the center with a tax surcharge on current residents. A current resident who pays the tax but moves to another state next year will be unfairly paying for twenty-nine years of the center that he or she will not benefit from. Alternatively, a new resident who moves into the community in the next year will get twenty-nine years of convention center benefits without bearing any of the costs. A more equitable alternative is to amortize the cost over thirty years, and require residents to pay taxes equal to that year's principal and interest. In this manner the center is paid for by current residents; theoretically, the people who are benefiting from it.

A cardinal principle of government fiscal responsibility is that a government or agency should never issue long-term bonds to finance its day-to-day operations. Doing so is an indication that current operating revenues are insufficient to cover current operating expenditures.

General Obligation and Revenue Bonds

Municipal bonds are often classified according to how they are secured (where the money to repay lenders will be coming from). General obligation (GO) bonds are secured by the full faith and taxing power of the bond issuer. In the case of county GO bonds, this means that county taxpayers are pledged to pay any taxes necessary to pay off principal and interest to the bondholders (lenders). Revenue bonds are issued to finance specific revenue-generating projects (toll roads, water systems, etc.) and the revenue generated by the project is the only security on the bonds. For example, if a sewage facility is financed by a revenue bond, then the only funds available to repay lenders will be the revenue generated by that facility; residents are not legally liable to use their tax dollars to pay bondholders. It remains debatable, however, whether or not the taxpayers in a community have a moral responsibility to make good on a revenue bond if it defaults.

WHAT SETS MUNICIPAL BONDS APART FROM OTHER DEBT INSTRUMENTS IS THAT THE INTEREST PAID TO BONDHOLDERS IS NOT SUBJECT TO FEDERAL INCOME TAX, OR IN GENERAL, TO STATE INCOME TAXES IF THE BOND WAS ISSUED IN THE STATE WHERE THE TAXPAYER LIVES.

Tax-exempt Interest

What sets municipal bonds apart from other debt instruments is that the interest paid to bondholders (lenders) is not subject to federal income tax, or in general, to state income taxes if the bond was issued in the state where the taxpayer lives. Because of the tax exemption, bondholders are willing to accept a lower interest rate on their investment than they would have if the interest were taxable. For example, if an investor is in the twenty-eight percent tax bracket and taxable bonds (corporate or federal government treasury bonds) earn a return of 10.0%, then the investor will earn an after tax return of 7.2%. Because no taxes are paid on municipal bonds, investors will be willing to accept returns of less than 10.0%, provided they are greater than 7.2%. In general, borrowers benefit because they pay less interest than do others who must use taxable debt, and lenders benefit because they usually get greater net returns than they do on taxable bonds.

Because of the tax advantages of municipal bonds, their primary investors tend to be those individuals and institutions in the highest tax brackets. The two largest investing segments of the economy, life insurance companies and pension funds, pay little or no income taxes, and they are therefore essentially uninterested in municipal bonds. Instead, the largest investors are high-income individuals, trust funds, municipal bond funds, tax-exempt money market funds, property insurance companies, and local banks. In addition, because of state income tax considerations, the market for municipal bonds tends to be

dominated by in-state investors. For example, very few bonds issued by Allegheny County will be purchased by investors outside Pennsylvania.

BOND RATINGS

The Rating System

Bond ratings are used to classify municipal bonds according to their risk of default: higher ratings imply less default risk, and hence lower interest rates. When dealing with 20 or 30-year bond issues, small reductions in the interest rate can lead to substantial savings in total interest paid. It is therefore extremely important to any issuer to maintain as high a bond rating as possible.

BOND RATINGS ARE USED TO CLASSIFY MUNICIPAL BONDS ACCORDING TO THEIR RISK OF DEFAULT: HIGHER RATINGS IMPLY LESS DEFAULT RISK, AND HENCE LOWER INTEREST RATES.

The two primary agencies that rate municipal bonds are Moody's Investor Service and Standard & Poor's, Inc. The table below shows the different ratings used by each agency. Finer gradations are made by each agency through the use of a plus or minus sign (S&P) or a 1 in place of the plus sign (Moody's). Allegheny County currently carries a AA rating from S&P and a A1 rating from Moody's. As indicated in the following table, these are fairly high ratings, implying that the County is considered a good credit risk.

Bond Ratings

	Highest Grade	Other Investment Grade	Speculative Grade	Default (Junk Bonds)
Standard & Poor's	AAA	AA,A,BBB	BB,B,CCC, CC	D
Moodys	Aaa	Aa,A,Baa	Ba,B,Caa, Ca, C	

Source: Intergovernmental Perspectives, Fall 1990, p. 32.

Factors Influencing Bond Ratings

Arriving at a bond rating for an issuer is not an exact science; there is no set formula into which one can input data and compute the rating. There are, however, a number of factors that can be identified as being important to the rating agencies, and they can be grouped into four categories: economic factors, debt factors, administrative factors, and fiscal factors.

Economic Factors. A government's ability to pay its debts in a timely manner depends on the underlying health of the local economy. Indicators include steady growth in income, employment and

population. If the tax system depends upon income-based taxes, then per capita income and median family income are important. Alternatively, if most revenues are raised from property taxes, then property values and overall wealth are looked at more closely. A healthy economy is also one that has a diversified economic base which does not depend too much on one firm or industry. Finally, the rating agencies consider patterns in retail sales, building permits, housing prices, utility hook-ups and other indicators of general economic health. Despite Allegheny County's generally good bond rating, the loss of population in the County is considered one of the more negative aspects of the local economy.

AT PRESENT, THE COUNTY HAS A TOTAL OUTSTANDING GENERAL OBLIGATION DEBT OF ABOUT $564 MILLION, WELL BELOW ITS LEGAL GENERAL OBLIGATION DEBT LIMIT OF OVER $2 BILLION.

Debt Factors. When evaluating new debt issues, rating agencies will evaluate the levels of past, present, and anticipated future debt relative to the government's overall budget. Long term debt service payments in Allegheny County have varied between 9.87 and 11.56 percent of the total budget during the past five years. At present, the County, including its institution district, has a total outstanding general obligation debt of about $564 million, well below its legal general obligation debt limit of over $2 billion. On a per capita basis, each resident of the County owes $375 in general obligation debt. For reference, the median amount owed per capita in counties with populations greater than one million residents is $415. When all debt, including revenue bonds, is included, the total debt outstanding becomes about $2.6 billion (principal and interest). The per capita figures for Allegheny and comparable counties are $1,924 and $1,521, respectively.

ADMINISTRATIVE FACTORS ALSO INCLUDE EVALUATIONS OF THE PEOPLE IN CHARGE OF THE GOVERNMENTAL UNIT.

In addition to the County debt, however, rating agencies also consider other debt obligations owed by residents. Referred to as overlapping debt, it comprises debt issued by cities, school districts, and other special districts in the County which also issue debt against the tax-paying ability of the same taxpayers. Even though the County's per capita debt may compare favorably to that of other areas, the plethora of debt issued by other borrowers in the County is pushing the total GO debt up towards the $2 billion cap. Along with unfavorable population trends, the high level of overlapping debt is one of the County's major problem areas with rating agencies.

Administrative Factors. Probably the most important administrative factor evaluated by the rating agencies is the government's source of revenue and any limits on its ability to tap that source. For example, analysts will want to know whether taxes are levied on property, income, or both, and how high current tax rates are relative to any

statutory or political limitations. They will evaluate the flexibility of the revenue source and estimate how stable it will be in the event of unexpected calamities. They will want to know if the tax collecting process is efficient, or if there is a high rate of delinquency or non-compliance. They will also examine how property assessments are determined and what impact, if any, changing assessment techniques will have on projected revenues.

Administrative factors also include evaluations of the people in charge of the governmental unit. Are they experienced, and do they have a good record of meeting their budget, especially during times of fiscal distress? Do labor and management work well together? Is there an excessive turnover rate of employees, and, in general how efficient is the local bureaucracy?

Administrative factors also include the scope of the government's responsibilities. It is important to know exactly what governmental functions must be continued, what functions can be reduced in scope, and what functions can be eliminated. Finally, administrative policies that rely on "one-shot quick fixes" to meet financial obligations are generally frowned upon by the rating agencies, unless they are a part of an overall program to regenerate future balances in the budget.

Fiscal Factors. The term "fiscal factors" refers to the financial performance of the governmental unit relative to its budget. Ratings analysts will examine the past history of the governmental unit to determine how successful it has been in meeting budget targets. The government's pension fund liabilities are also examined closely because they reflect significant future financial obligations. Rating analysts like to see fully funded retirement plans. The County's current unfunded pension liability is about $100 million, but it is estimated that the unfunded liability will be eliminated by the year 2001.

AS A RULE OF THUMB, ANALYSTS FEEL THAT A FUND BALANCE SHOULD BE EQUAL TO AT LEAST 5% OF THE ANNUAL BUDGET.

Maintaining an adequate financial reserve is essential to sound financial management. Revenue or expenditure estimates may be inaccurate, a major employer may shut its doors, or a general economic downturn may occur, causing revenues to decrease and expenditures on social services to increase. As a rule of thumb, analysts feel that a fund balance should be equal to at least 5% of the annual budget. Using this rule, the County's $515 million budget (approximate) would require about $26 million in reserve. Current estimates are that the County's general fund balance will be about $37

million, leaving $11 million available to fund tax cuts while maintaining the desired five percent balance.

There are some instances where the lack of a budget surplus would not necessarily have a negative impact on a bond rating. A history of meeting budget targets, successfully coping with emergencies, and some latitude in expenditure levels during bad times all combine to decrease the importance of a reserve fund.

Rating Changes

Bond ratings are assigned or updated on a continual basis. Each new bond issue will be rated. In addition, the community's rating will be reviewed on a periodic basis to provide information to the secondary bond market (where previously issued bonds are bought and sold). Major bond issuers (this would not include Allegheny County) are reviewed on a quarterly basis and others are reviewed less frequently.

The rating agencies follow state and local news very closely, and rating reviews can be triggered by significant current events. In all likelihood, the recent change in government and the controversy over assessment freezes in Allegheny County have caught the attention of the bond rating agencies. In many such instances, the rating agencies issue credit warnings for the affected governmental unit. These warnings are not necessarily negative; they are simply an indication that important events are occurring in the jurisdiction. Unless changes are drastic, the rating agencies will usually put a jurisdiction on credit alert for a period of a few months before actually changing a rating (either up or down).

IN MANY INSTANCES, THE RATING AGENCIES ISSUE CREDIT WARNINGS FOR THE AFFECTED GOVERNMENTAL UNIT. THESE ARE NOT NECESSARILY NEGATIVE, THEY ARE SIMPLY AN INDICATION THAT IMPORTANT EVENTS ARE OCCURRING IN THE JURISDICTION.

Bond Insurance

A governmental unit that has a low bond rating can reduce its borrowing costs by purchasing bond insurance. In the event that the government is unable to meet its principal and interest commitments, the insurance company will make all required payments. Under these circumstances, it is the creditworthiness of the insurance company, not the governmental unit, that determines the bond rating and the interest rate. Insured bonds generally carry AAA ratings. In essence, the availability of insurance allows bond issuers a method whereby they can counteract the interest rate consequences of a reduced bond rating.

The price of the insurance premium varies with the credit rating of the borrower and the market demand for insurance at the time of issue. Premiums average between 20 and 25 basis points (0.0020 to 0.0025) of the total principal and interest payouts over the life of the bond. Although the premium is payable when the bond is issued, it can be folded into the bond issue and amortized over the life of the bond.

Despite its strong rating, Allegheny County purchased insurance on its last GO debt issue in May, 1995. By doing so, it was able to sell its bonds with a AAA (Aaa) rating, and it was determined that the interest savings obtained with the better rating more than made up for the extra cost of the insurance premium. The total principal and interest for the $23 million bond will be about $38 million, and the insurance premium was 16 basis points. The total cost of the insurance was therefore about $61,000, or $5,105 per year for 20 years (discounting at 5.5%).

Allegheny County is planning to issue about $90 million in new general obligation debt in late 1996. If the County's AA rating holds, and the County can purchase insurance at the previous rate of 16 basis points, the total cost of the insurance would be $240,996, or $20,166 per year (discounted at 5.5%). However, finance professionals are predicting the insurance premium to be closer to 10 basis points. Therefore, the total cost of the insurance would be $150,623, or $12,604 per year (discounted at 5.5%.)

INSURANCE PREMIUMS REPRESENT AN INSIGNIFICANT PORTION OF A $500 MILLION BUDGET.

Although it is unlikely that a rating change would occur by then, suppose a fiscal crisis causes the County's rating to decrease to the level of the City of Pittsburgh: Baa1 (according to Moody's) or BBB+ (according to S&P). The City purchased bond insurance on its most recent debt issue of $75 million for a price of 23.4 basis points, and with the insurance, the City bonds were rated AAA and Aaa. If the County could get insurance for the same price (as noted above, premiums vary with market conditions), the cost of the premium would be $352,457. Discounted over 20 years, the annual cost of the premium would be about $29,494, or only $9328 per year more than the cost of insurance with the current AA bond rating. Compared to the county's $730 million overall budget, $9328 is an insignificant amount; it represents less than a penny per county resident.

CONCLUSION

It is possible that the rating agencies are already looking at Allegheny County because of the significant change in government leadership that has recently occurred. On the one hand, they may be welcoming a team that promises more fiscal conservatism and a smaller government sector. On the other hand, however, they are also now dealing with an unknown quantity. Regardless of its fiscal philosophy, the prior administration was a known quantity with an established record of meeting its budgets.

In the final analysis, however, we must ask ourselves how important it is to keep our bond rating where it is. The most important consequence of a lowered rating used to be the higher interest costs associated with a debt issue. However, the financial cost of a lower bond rating can be reduced through the use of bond insurance. The true cost is merely the higher insurance premium. As noted in the report, the financial cost of bond insurance is insignificant when compared to the overall budget.