Impact of Federal Fiscal Troubles on New England Local Governments

For some time, the executive and legislative branches of the United States government have been trying to come to grips with the yawning federal deficit.

The executive branch, particularly under President Barack Obama, has had one approach to addressing this issue. The legislative branch, particularly with a Republican-led Congress, has had a different approach. The attempt to bridge this gap – and difficulties in doing this – has had a number of impacts on local governments nationally, including in New England.

Debt Limit

In late December, borrowing by the United States government had pushed its debt level close to the statutory debt limit set by Congress and the President. As it has a number of times in the past several years, Congress did not approve an increase in the debt limit. One consequence of this was that the United States Treasury closed its SLGs window. SLGs, which is an acronym for State and Local Government series, are a special type of obligation issued by the Treasury, specially for the use of state and local governments. Most often, SLGs are used to fund escrows created to advance refund tax-exempt municipal bonds. SLGs are, in fact, the most efficient vehicle for funding relatively small advance refundings until they are callable. The maturity dates of these securities are tied to the exact payment dates of refunded debt service, reducing inefficiencies in the escrow.

When the Treasury closed the SLGs window, municipalities that were issuing advance refunding bonds needed to decide whether to proceed with the advance refunding using “open market securities” or to delay the issue until the SLGs window reopened. “Open market securities” are simply securities that are purchased from a dealer on the open market. Examples include Treasury Bonds and Notes. Unlike SLGs, these securities have set maturities that do not always match refunded debt payment dates creating inefficiencies in the escrow. In order to use such securities for an advance refunding escrow, municipalities must follow detailed rules set forth by the Internal Revenue Service regarding the seeking of offers (or bids) of securities from dealers. In order to ensure compliance with these rules, municipalities seeking to use open market securities engage the service of a bidding agent, which can add to the cost – or reduce the savings – of a refunding issue.

Municipalities issuing relatively small amounts of advance refunding bonds might find that retaining a bidding agent would reduce savings to an unacceptable level. In this case, a municipality might delay the refunding issue until the SLGs window reopened. Some of our clients elected to go with a bidding agent, while others elected to wait on the SLGs window reopening.

On February 5, 2013, President Obama signed legislation that suspended the debt limit until May, 2013. Within a few hours, the U.S. Treasury reopened the SLGS window. Advance refundings could now proceed with the use of SLGs.

This is not the end of the story. The Treasury and others have commented that the SLGs window could well close again in May when the suspension of the debt limit expires. We could see, as we have seen in the past, the SLGs window close from time to time in the future as Congress and the President grapple with the deficit. For municipalities with bonds that can be advance refunded, this is worth watching.

Sequestration

One of the ways in which the President and Congress tried to address the federal deficit was to create the so-called "fiscal cliff." This was a deadline at the end of 2012 by which the different branches of the federal government needed to come to agreement on revenue and expenditure issues. Failing this, automatic revenue increases and expenditure reductions were to go into place. As it happens, the President and Congress were able to come to a temporary agreement that prevented those revenue increases and expenditure reductions from happening.

Again, this is not the end of the story. There is the possibility that if the temporary agreement breaks down, the revenue increases and expenditure reductions could happen. The expenditure reductions would be accomplished by a sequestration of funds already appropriated by the federal government. These funds have already been appropriated by Congress, but would be withheld if the temporary agreement breaks down. Many non-defense and non-entitlement programs would be affected by sequestration. If nothing changes, this sequestration will happen on March 1, 2013.

Beyond the federal grants that many municipalities receive for education, transportation, and environmental purposes, subsidies on tax credit bonds could be affected. These bonds, which include "Build America Bonds," Qualified School Construction Bonds, and Qualified Energy Conservation Bonds, have been issued by many local governments throughout New England. The subsidies that these governments have been receiving from Washington could be reduced, increasing the amounts that they need to appropriate for debt service on these bonds. Finance officials in municipalities that have issued, or plan to issue, such debt should follow this situation as they plan their fiscal 2014 budgets.

Other Proposals

There have been alternative proposals to address the budget deficit by focusing on some "sacred cows." These include deductions on home mortgage interest and state and local taxes. These could have serious indirect effects on municipalities. Eliminating the home mortgage interest deduction could put further downward pressure on real estate values. Eliminating the state and local tax deduction could put fiscal pressure on municipalities in a number of ways. For example, eliminating the deductibility of property taxes would likely reduce taxpayers' appetite for a given level of local taxation. The "sacred cow" that has the most direct effect on municipal finance is the deductibility of interest on municipal bonds and notes from federal income taxation. So far, none of these proposals have gone very far in the legislative process, but they are worth watching as time goes on.

Other Potential Consequences

Over time, as Washington deals with the deficit, the direction of the deficit could have a profound effect on interest rates. The current low interest rate environment is the product of, among other things, the federal government's fiscal and monetary policies and investor confidence in the United States and the dollar. Significant changes in any of these factors could produce a dramatic change in the interest rates we have seen over the past several years. This could have a dramatic effect on how municipalities, like everyone else in our country, does business, particularly as it relates to financing capital projects.