

Hot Topic: Special Comment

Moody's U.S. Public Finance

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HEA 1001-2008 Circuit Breaker Could Negatively Impact Underlying Local Government Credit Quality in Indiana

Summary

Sweeping changes to the way local governments are financed made during the most recent legislative session could have negative credit implications on balance, despite some elements which are viewed as credit positives. The magnitude of the impact HEA 1001-2008 will have depends on several factors, the most significant of which are: the type of governmental unit in question, existing property tax rates, and the composition of its assessed value. Over time, the impact of the legislation could result in deterioration of credit quality, but has not yet led to any rating downgrades. Moody's believes that to a large extent, the preservation of credit quality will hinge significantly on a governmental unit's ability to navigate the structural changes embedded in the legislation, quantify and plan for fiscal challenges which might arise as a result, and demonstrate a willingness to make difficult budgetary decisions if necessary. In that context, rating outcomes will be made on a case by case basis.

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Impact To Underlying Credit Quality Under HEA 1001-2008

HEA 1001-2008 Part of Broader Restructuring of Local Government Finance

Circuit Breaker Limits Lower Than HEA 1001-2006

Expanding upon, and further tightening the limitations on the amount of property taxes a taxing unit may collect instituted during 2006 (HEA 1001-2006), changes made in the 2008 legislation are projected to result in steeper reductions when fully phased-in by 2010. The Circuit Breaker as certified by each county auditor, now limits tax payers' total tax liability in 2009 to 1.5% of a property's gross assessed value for homesteads, 2.5% for other residential and agricultural land, and 3.5% for other real and personal property. For example, if a homestead property's assessed value is \$100,000, and the prior tax liability was \$2,000, the maximum liability would be capped at \$1,500 after applying the Circuit Breaker, resulting in an aggregate loss of \$500 for all units of government levying against that parcel. These caps are scheduled to further narrow in 2010 to 1.0%, 2.0%, and 3.0%. There is no provision which explicitly states how the resulting shortfall would be apportioned across the various overlapping taxing authorities, but it likely will be on a pro-rata basis. The legislations specifically excludes taxing units from adjusting their levy to compensate for the loss, and are likewise prohibited from issuing debt to compensate.

An effort to quantify the net dollar impact resulting from applying the revised Circuit Breaker limits was undertaken by the Legislative Service Agency (LSA) earlier in the year. Since then, some Indiana municipalities have opted to conduct their own more detailed analysis. While the different studies have resulted in moderately divergent outcomes, several themes emerge in aggregate. The severity of lost property tax revenues varies dramatically across the state. In some cases the projected loss is mild. Other local governments who fared well under the previous limits now face steeper reductions, and in certain instances the projected loss could become severe. In general, the differences arise from the varying existing tax rates (which determine what values the Circuit Breaker will be applied against), and the composition of the local assessed value (which dictates which of the three caps is applied).

Changes More Expansive Than Simple Levy Caps

Beyond codifying Circuit Breaker levy limits, HEA 1001-2008 includes an extensive array of additional changes not contained in the original 2006 Circuit Breaker legislation, having different implications for cities, counties, school districts, and other taxing jurisdictions.

Among the most notable provisions specific to schools are:

- A school's General Fund will now be 100% state funded (compared to 85% previously)
- To help districts transition through the Circuit Breaker, the state is providing direct relief to school districts during 2009 and 2010 totaling \$120 million
- Districts now have the option to seek voter support via referendum for levy support outside Circuit Breaker limits (for a maximum of 7 years)
- The rules governing the use of Capital Project Fund dollars are loosened, and can be earmarked for Circuit Breaker losses
- Districts now have non-voting representation on redevelopment commissions

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For cities and counties important changes include:

- Most importantly, the state assumes 100% of the costs of Pre-1977 police and fire pensions (previously it had funded roughly 50%)
- The state assumes the responsibilities of a number of social services traditionally shouldered by counties
- The state furthermore assumes 100% of costs to incarcerate juvenile offenders (which previously been a contentious issue)
- To help offset some of the lost property tax revenues, the law allows for the creation of up to a 0.25% Local Option Income Tax (LOIT), to be used specifically for budget increases, property tax relief, or public safety expenditures
- Allows units to appeal to a Distressed Unit Appeal Board if tax collections are reduced by at least 5% due to the Circuit Breaker, which then has the option to consider placing some or all taxes imposed for debt service outside the Circuit Breaker
- Repeals or changes the effective dates on a number of previous appeals for maximum levy exceptions

HEA 1001-2008 contains additional language on debt structure:

- All debt payable from property taxes must be repaid within 20 years (25 years for tax increment districts)
- Debt service payments are to be structured substantially level, but makes allowance for accelerated repayment, or to layer onto an existing debt structure such that the aggregate schedule is level
- Refunding bonds cannot have a maximum maturity which extends beyond the life of the refunded bonds
- All savings derived from a refunding are to be used to offset future debt levies or debt outstanding
- Controlled projects exempted from remonstrance/referendum if project is due to natural disaster or other emergency

Legal Security Clarified For New Debt; Standing of Prior Debt Still Unclear

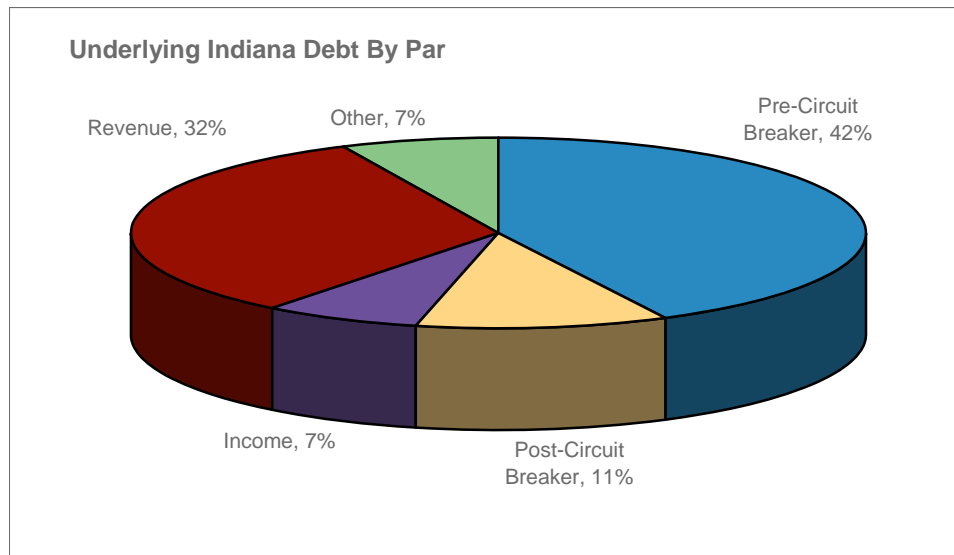
One of the most significant issues of the prior Circuit Breaker (HEA 1001-2006) was what it did not contain: explicit language definitively and unambiguously asserting the legal standing of prior debt obligations backed by an unlimited ad valorem tax pledge which had been issued prior to the Circuit Breaker becoming law. The statutory language did not exempt debt levies from the Circuit Breaker caps, but it also did not alter or repeal the prior statutes governing the unlimited pledge. Moody's continues to take the position that implied GOULT debt issued prior to HEA 1001-2006 be viewed as such based on the belief that bondholders have a reasonable expectation of enforcement of the binding terms in force at the time of issuance – the unlimited tax pledge. Debt issued once HEA 1001-2006 became law however, was analytically viewed as a limited tax obligation.

While technically a lease, Moody's has historically treated first mortgage obligations on parity with an issuer's GOULT rating, or implied GOULT rating when none exists. Debt service (prior to HEA 1001-2006), carries an unlimited ad valorem tax pledge, not subject to appropriation. The only circumstance which would prevent lease payments being made would be if the project were substantially unfit for use (i.e. a building became severely damaged or destroyed). Most indentures therefore require insurance not only for the full value of the mortgaged asset, but also carry the requirement for two years worth of rental insurance to cover principal and interest payments during the presumed reconstruction period.

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The language contained in the new Circuit Breaker legislation (HEA 1001-2008) clearly defines which types of future debt are to be repaid under levy caps, and which classes of debt are payable from levies outside of the caps. The new legislation furthermore explicitly places debt service levies of all prior property tax obligations for units of governments in Lake and St. Joseph counties outside the caps. HEA 1001-2008 did not however address the standing of debt service on prior obligations located in the other 90 counties.

The new legislation additionally codifies the requirement that all debt service receive a senior claim on all revenues of a taxing unit, to be paid prior to operating expenses; previously that had only been the Department of Local Government Finance (DLGF) administrative policy, but it carried no legal endorsement. Furthermore, statute now directs the state treasurer to intercept LOIT disbursements or other state money allocated for a government to cover any shortfalls for debt service which might occur, in a manner similar to the post-default state intercept for schools. Despite debt service receiving priority and an intercept mechanism put into place (Moody's views post-default intercepts as a relatively weak structure) which could add some strength to the credit in question, it is the fundamental underlying security, limited or unlimited tax pledge, which forms the basis of our ratings and opinions.



Local Government Credit Profile Potentially Weakened; Strong Management Essential to Preserving Credit Quality

Several provisions contained in HEA 1001-2008 can be viewed as credit positives, some of whose benefits will be more immediate than others. The regulations governing debt structure cited above will help to curb some of the weakest of debt management practices from arising, which, while not a significant existing problem among Moody's rated issuers in the state, does help tighten the parameters under which debt can be issued. Additional benefits could take time to be fully realized (if at all). In return for assuming 100% of the pre-1977 police/fire pension costs, the state is requiring localities to reduce their levy by the corresponding increase in additional state pension relief beginning in 2009. Similarly, counties will see specific social service-related levies eliminated concurrent with the state assuming the corresponding responsibilities. Since revenues will be reduced by an amount equal to state relief, the immediate impact of removing pension and certain social service responsibilities by the state will likely be minimal. However, since these items are largely non-discretionary and have the potential for unpredictable or escalating cost growth, local government budgets should benefit over the long term. The most important positive outcome of HEA 1001-2008 is that it brings legal clarity to the underlying security of all future property tax backed debt, unambiguously creating both limited and unlimited types of property tax debt.

Despite these potential credit positives, most units of government throughout the state will face a reduction of property tax collections of varying degrees by 2010. With limited revenue raising alternatives beyond the new LOIT authority (and possibly relief from the Distressed Unit Appeal Board), many entities could face mild to

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significant operating pressures, possibly causing acute competition for the funding of daily operations to emerge which could affecting credit quality, even if debt service is fully funded. Realigning budgets and containing expenditure growth will likely be the most critical factor in maintaining structurally balanced budgets as the levy caps are phased in. The strength, depth and responsiveness of management, always a fundamental credit factor, will become even more crucial to preserving credit quality through the transition and beyond. The absence of a clearly articulated, feasible plan to navigate the budget challenges specific to the individual issuer could put downward pressure on a credit rating. As such, the impact of HEA 1001-2008 on credit analysis will be made on a case-by case basis.

Moody's Related Research

Special Comments:

- [Moody's Approach to Rating Tax Backed Obligations of Indiana Local Governments In Light of Recent Circuit Breaker Legislation \(97753\)](#)
- [General Fund Balance-- One Size Does Not Fit All \(74269\)](#)

Rating Methodology

- [The Determinants of Credit Quality \(75047\)](#)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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