Assessing State and Local Government Debt Refinancing Measures.

The Great Recession was brutal for states and municipalities, and the weak recovery since has been little help. Revenues are down, yet bonds issued during the flush times still need to be honored. At the same time, the costs of unfunded pensions have continued to rise, further complicating a difficult financial situation.

In response, many states and municipalities have refinanced their current debt obligations — the annual recurring payments they make to repay borrowed money to finance various projects, known as "debt service" — or are considering doing so. By changing the original finance terms to reduce the portion of each payment that goes toward principle or interest, governing bodies can ease short-term budget pressures and free up cash for essential government operations. The flip side is that this draws out repayment and increases the total amount of interest paid, a cost born potentially by future generations. Governments are also effectively betting that in the long term, revenues will rise — something they may or may not do.

A 2014 study in *State and Local Government Review*, "Not All Refinancings Are Created Equal: A Framework for Assessing State and Local Government Debt Refinancing Measures,"looks at the range of strategies used by states and municipalities when seeking to refinance their debt obligations. The author, Martin J. Luby of DePaul University, develops an assessment framework for debt restructuring and also provides a series of recommendations for governments. He draws a distinction between "hard liabilities" such as municipal bonds — legally enforceable financial agreements that must be repaid on a schedule — and "soft liabilities," which include pensions, unemployment trust fund benefits or vendor bills. Debts are classified as ''soft'' when their full future costs and timeliness payments can only be estimated. Each kind of debt has its own strategy: For hard liabilities, governments typically replace old bonds with new ones that stretch debt repayment out over a longer period, reducing short-term obligations. Soft debt can sometimes be switched to hard debt — for example, through the sale of pension obligation bonds (POBs).

Luby emphasizes four principles that can help when assessing the prudence of any debt-refinancing approach. The first, "intergenerational equity," refers to the relative burden of debt agreements on present and future generations. To be considered "prudent," any agreement signed in the present should not unduly burden future generations. The second, "economic efficiency," requires that governments weigh the relative opportunity costs of refinancing now or later — if it can be done later at a greater savings amount, that could be the more appropriate decision. The third, "measurability/certainty," asks that the forgone future resources required by any refinancing be clearly understood, as well as their opportunity costs. Finally, "management flexibility" is the degree to which refinancing constrains or frees future financial decision-making.

Looking through the lens of the four principles, the author lays out a series of best practices:

- **Carefully evaluate debt restructuring strategies**. Because debt restructuring involves shifting payments from present generations to those in the future, "it violates the principle of intergenerational equity and this type of refinancing is generally economically inefficient." If

governments do chose to restructure their debt to reduce present-day burdens, they have an obligation to quantify and disclose the additional interest costs so that the public fully understands the short-term benefits and long-term costs of such actions.
- **Disclose which taxpaying generation benefits from up-front refinancing.** Debt can be restructured in ways that provide savings over time or all up front — a "one-shot" burst of revenues. Distributed savings are considered more prudent, as they have greater equity and don't exacerbate budget deficits. "As an active means of discouraging [one-shot] structures, state and local governments should also be required to disclose the interest savings schedule by year for all bond refinancing so the public knows in what years the savings are being captured."
- **Avoid refinancing that involves risky arbitrage schemes or that does not provide guaranteed benefits.** Because savings from debt restructuring should be both measurable and certain, restructuring that is subject to future market conditions should be carefully examined. "In the case of 'arbitrage plays' like POBs, these transactions are incredibly risky and should generally be avoided especially for state and local governments whose finances are already shaky."
- **Continue to monitor the bond markets for unique refinancing opportunities**. While volatile credit markets can cause difficulties for state and local governments, they also create opportunities for economically efficient debt structuring. "State and local governments should encourage their capital market partners (i.e., their underwriters and financial advisors) to actively monitor the bond markets for such opportunities and bring creative refinancing ideas to their attention."
- **Limit statutory constraints placed on debt managers in their debt refinancing decision making**. While there are many examples of imprudent state and local governments, "decreased managerial autonomy can lead to suboptimal financial decisions/results compared to debt managers who possess more bureaucratic decision-making power."

In conclusion, Luby writes: "Taxpayers and other stakeholders need to be aware of the short- and long-term effects of particular refinancing strategies to understand the efficiency, intergenerational equity, measurability/certainty, and management flexibility impacts of these transactions."

In an accompanying article in the same journal, "Refinancing State and Local Debt: Decreased Current Costs or Decreased Future Flexibility?" Bruce J. Perlman of the University of New Mexico reviews some of the key points of Luby's paper and extends the analysis. "Borrowing may be especially tempting for state and local governments right now," Perlman writes. "After all, money is relatively cheap, interest rates are down, government bond yields are good; now is a favorable time to borrow, so it may be tempting for state and local governments to restructure obligations." Consequently, it can be an acceptable trade-off to pay less today when financial pressures are greater and more in the future when increased revenue is anticipated.

Given such temptations, Perlman suggests several key considerations for municipalities. In addition to emphasizing the need for intergenerational equity, he notes that municipal managers can no longer count on linear financial projections relating to debt, as they have done for much of the past — as even middle-term outcomes can be highly uncertain. Finally, there is simply no eliminating risk: The use of interest rate swaps, which were intended to limit the downside of inflation and interest rate rises, can become money-losers, as they have for Detroit and other municipalities. Ultimately, Perlman argues, policy makers looking to make wise debt-restructuring decisions should ask certain core questions, such as "whether this debt has been carried too long by the state or local government and is a stranded asset or whether the debt will be projected too far beyond its useful life or even the lives of those who incurred it originally."

Related research: A December 2013 Federal Reserve working paper, "Are U.S. State and Local Governments on a Fiscally Sustainable Path?" examines the growing disconnect between state and local governments' income and expenditures — sometimes called a "structural deficit" or "fiscal instability." They find that the per-capita gap between state and local income and mandatory obligations has been growing for the past three decades, with a shortfall of approximately $1,100 per capita in 2010. The largest contributor to the growth in state and local financial obligations was in service and income maintenance, which includes public welfare, hospitals, health, and social insurance administration but excludes unemployment insurance and workers' compensation. States with larger gaps tend to have a larger population and higher unemployment rates.

By Leighton Walter Kille | April 24, 2014