Gurtin Municipal Bond Management

Municipal Credit Research Report

State of Texas Aims to Restrict Local Governments' Ability to Raise Revenues

April 2015

Executive Summary

Momentum builds in Texas legislature to reduce local governments' ability to raise revenues, with Texas legislature considering an array of restrictions on raising revenues, exact details remain vague.

Texas' consideration of local government revenue raising restrictions reduces the power of what has historically been a vital tool for Texas local government obligors – the wide latitude to raise tax rates which has enabled control of their own destiny.

Unique factors make Texas' consideration of revenue caps potentially dangerous for investors.

- Rapidly growing Texas local governments, many of which are amongst the fastest growing in the nation, may struggle with revenue restrictions given significant expenditure and debt pressures generated by surging populations.
- Volatile oil and gas valuations pose another unique threat; reducing local governments' capacity to raise tax rates removes a major tool used to combat this sector's valuation declines.

- No increase in State aid expected to offset any lost local revenues.

Texas local governments' reliance on limited tax debt makes any revenue raising restrictions concerning for investors.

Momentum builds in Texas legislature to reduce local governments' ability to raise revenues raising capabilities, with Texas legislature considering an array of restrictions on raising revenues, exact details remain vague.

On January 20, 2015, Governor Greg Abbott was sworn in as Texas' new governor, and along with other state officials, quickly announced plans curb local governments' tax raising authority. The impetus for restraining local governments' revenue raising abilities appears to be at least in part a consequence of the perception that local debt and taxation levels remain unacceptably high. The Texas Bond Review Board published its annual Local Government Report in March 2015, just as the legislative session was commencing, and highlighted a number of trends that state officials have cited when lobbying for new tax constraints. Among the notable findings were: debt per capita levels in Texas had increased by 50.5% over the past decade while the state's population had grown by 19.9%, tax-supported debt (or general obligation bonds) had grown by 12% in the past five years, and Texas now had the second most local debt per capita among large states, trailing only New York.[1] Interestingly, while the legislature has fixed its gaze squarely on cities and, to a lesser extent, counties as the source of the problem, Texas' school districts are the largest source of local government debt and property tax revenue by a wide margin.

At the time of publication, state officials have effusively discussed concepts, but have been frustratingly vague on specifics detailing the restrictions they prefer. The proposed legislation runs the gamut from capping the amount of property appreciation that could be taxed (as property values rise, only a small portion of the increase would be subject to property taxes), to restricting the ability to raise tax rates without going to voters, to limiting outright revenue growth to a set percentage. All of these restrictions would result in city and county governments dealing with new limits and restrictions on their ability to raise revenues. Ultimately, if any legislation is passed, the devil will be in the details.

Texas' consideration of local government revenue raising restrictions reduces the power of what has historically been a vital tool for Texas local government obligors – the wide latitude to raise tax rates which has enabled control of their own destiny.

Two of the primary traits that we believe high quality obligors share are strong financial flexibility and a control over their own destiny. These traits are the crucial underpinnings that provide high quality obligors the resilience to weather periods of turbulence. Financial flexibility has many forms; it may be characterized by ample reserves that provide a cushion against volatility, or an unfettered and practical capacity to raise tax revenues when needed. These levers of financial flexibility furnish high quality obligors with the

[1] Texas Bond Review Board, "Local Government Annual Report: 2014," March 2015.

wherewithal to control their own destiny, or in other words, actively shape their fiscal trajectory by way of revenue and expenditure decisions. In the absence of these levers, we believe that many municipal obligors do not have control over their own destiny and are created as passive actors unable to effectively respond to the challenges and opportunities in varying economic environments. These obligors often have no ability to raise tax rates, no reserves, and high levels of fixed expenditures which cannot be reduced.

Historically, Texas local governments have benefited from a strong ability to control their own destiny. Cities and counties have been statutorily provided wide latitude to raise their tax rates which has served them well during periods of economic stress. However, the State has chosen a uniquely precarious period in time to look at curbing local governments' revenue raising capability. We suggest that a number of unique factors make this a particularly dangerous time to limit obligors' financial flexibility, including: explosive population growth which has resulted in skyrocketing municipal service demand as well as the outsized exposure of many Texas obligors to the volatile oil and gas sectors which is likely to diminish many local governments' property tax bases in coming years. Additionally, whereas many other states simultaneously augmented state support to local governments to at least partially off-set lost revenues when imposing similar revenue raising restrictions on local governments, Texas is not considering any increase in local support and we believe is unlikely to do so.
We opine that the State's current consideration of legislation to reduce local governments' revenue raising capabilities poses a threat to financial flexibility and ultimately may impair weak obligors' ability to control their own destiny.

Unique factors make Texas' consideration of revenue caps potentially dangerous for investors.

Why do revenue caps and restrained local control over debt and finances pose a potential threat to Texas obligors? After all, we see a variety of tax caps in other states, many of which closely resemble the conceptual proposals put forth in Texas. We posit that Texas local governments' extraordinarily rapid growth, volatile oil and gas valuations, and lack of offsetting increased State aid potentially pose unique risks to investors.

Rapidly growing Texas local governments, many of which are among the fastest growing in the nation, may struggle with revenue restrictions given significant expenditure and debt pressures generated by surging populations.

A unique and significant problem for Texas local governments is growth. Financial flexibility is an absolutely essential tool for obligors to successfully manage explosive growth and all of its resultant service and infrastructure demands. Rapidly growing obligors confront expenditure volatility that necessitates the flexibility to nimbly augment annual revenues. Many Texas local governments are confronting hyper growth rates that are unfamiliar to most municipal governments. To put this in perspective, the U.S. Census Bureau's 15 fastest growing cities in the nation included 7

Texas cities – nearly half of the list.[2] It is common to find already populous cities in Texas experiencing 5% population growth per year – a rate more typical for many local governments over a decade.

As an example of the tremendous strain that rapid growth places on local governments' finances, we looked at the City of Cedar Park's financial and demographic trends over the past decade. Cedar Park is a rapidly growing suburb of Austin, and according to the Census Bureau the fourth fastest growing city in the nation (third fastest growing in Texas behind San Marcos and Frisco). As Austin has dramatically grown in recent decades, its suburbs have also boomed. Cedar Park had only 5,161 residents in 1990. Just ten years later, its population had grown by over 400% to 26,049. The explosive growth did not abate, between 2000 and 2010 the suburb's population expanded by an additional 90%. In just 20 years, Cedar Park's population had grown by an eye-popping 848%. The tale of Cedar Park is a similar story to many other rapidly growing suburbs in Texas' major metropolitan areas.

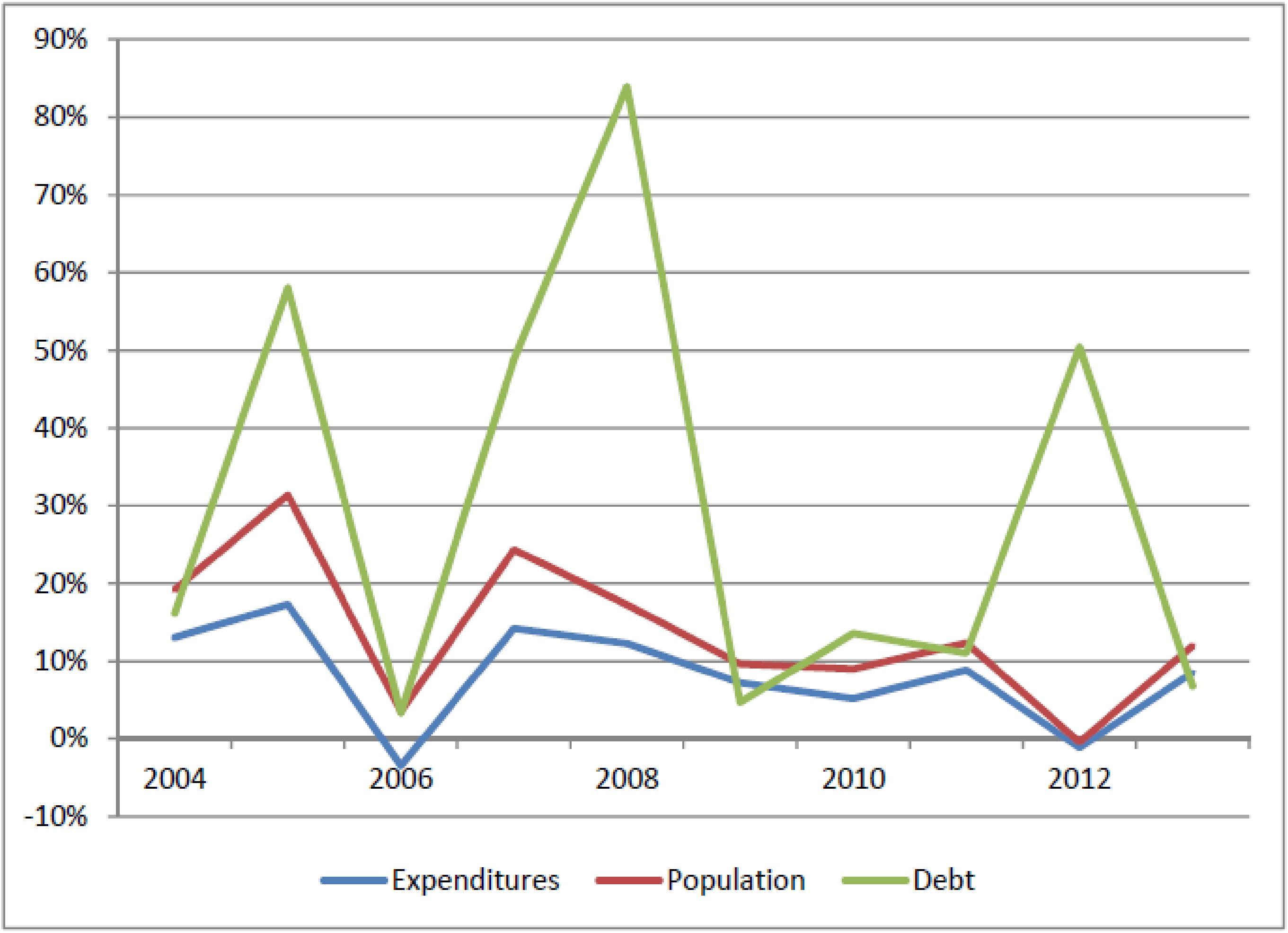
Figure 1 below illustrates that as the Cedar Park's population exploded, its expenditures and debt rapidly grew as well. Between 2003 and 2013, the City's governmental expenditures increased by 116% and its debt increased by 257%. This is unsurprising when you consider the infrastructure and service needs that come along with population levels that are nearly doubling in size each decade. With every new household comes the need for new roads, police and fire services, utilities, parks, libraries and an assortment of other municipal services demanded by residents. The City's expenses have grown on average by just over 8% annually since 2003 – an extremely fast annual growth rate for local governments. The U.S. Census Bureau's latest data shows that municipal expenditures nationally increased by 14% between 2007 and 2012, while during the same period, Cedar Park's expenditures grew by well over twice this rate at 36%.[3] If Cedar Park, and other similar cities, were left to manage this type of growth with restrictive revenue caps in place, it is easy to see how fiscal distress could occur as expenditure growth overwhelmed their ability to raise revenues.

Figure 1 also illustrates the nearly impossible task of keeping debt levels constrained when faced with the challenge of managing the type of growth Cedar Park has experienced. Many of the infrastructure demands created by new residents are far too costly to finance with cash on hand; further, as with any investment, the results will benefit and be shared by future generations. It is logical for cities to issue debt to support infrastructure thereby allowing future generations to help share in the payment of the cost of these capital improvements.

[2] U.S. Census Bureau, "The 15 Fastest Growing Large Cities with Populations of 50,000 or more from July 1, 2012 to July 1, 2013," Released May 2014.

[3] U.S. Census Bureau: Census of Governments (2012).

Figure 1: Cedar Park, Texas: % Change in Expenditures, Population and Debt (2003-13)[4]



Volatile oil and gas valuations pose another unique threat; reducing local governments' capacity to raise tax rates removes a major tool used to combat this sector's valuation declines.

It is no secret that Texas' economy is still heavily reliant on oil and gas despite its major metropolitan areas having diversified economically in recent decades. While the State's overall economy may be weaning itself from a near total reliance on oil, many Texas local governments still have tax bases and local economies that are dominated by the sector. While these obligors have benefited from the astronomic rise in valuations as oil prices marched upwards, they are now experiencing the recurring fiscal dilemma of plummeting property values as oil prices have fallen precipitously. Historically, local governments have combated falling valuations in this volatile sector by raising tax rates – so that as values decline, they would raise rates to minimize or even negate any potential property tax loss. The State's consideration of revenue raising constraints will remove a major tool in local

[4] All data taken from Cedar Park, Texas' comprehensive annual financial reports. Expenditures are Total Primary Government Expenses and Debt is Total Primary Government Debt.

governments' arsenal for battling the volatile oil and gas industry.

No increase in State aid expected to offset any lost local revenues.

Many of the other states that have enacted local government tax caps did so while also boosting state aid to offset at least a degree of the revenue losses resulting from the new restrictions. Texas is not considering any such increase in support to local governments. In fact, the State is currently considering a $4.6 billion tax cut package that is likely to constrain the State's ability to take on significant new spending.

Texas Local Governments' Reliance on Limited Tax Debt Makes any Revenue Raising Restrictions Concerning for Investors.

Beyond the challenges of managing to meet exploding expenditure needs with new revenue restrictions or combating diminished property tax bases as oil and gas valuations plummet, the proposed restrictions also pose a potential concern for investors given Texas local governments' reliance on limited tax securities to issue debt. Unlike local governments in many other states that primarily issue voter approved unlimited tax general obligation debt, Texas cities and counties rely heavily on limited tax debt. This means that bondholders do not benefit from a legal promise to levy a property tax without limitation as to rate or amount to repay them, but rather rely on Texas local governments' pledge to levy property taxes within the limits set by state statute. Therefore, any new revenue caps could potentially impact obligors' ability to raise the amount of revenue needed to pay both operating expenses and debt service.

Again, the devil will be in the details given that little discussion has occurred thus far on how to treat local government debt under proposed restrictions. However, it is concerning that many of Texas' fast growing local governments have locked in fixed debt service costs for decades to come through substantial amounts of debt issued using an assumption of current levels of local control to raise sufficient tax revenues to service the debt. Under new restrictions, these fixed costs could pose problems as additional tax revenues become scarcer and debt costs are competing with other municipal expenditures.

Conclusion

Gurtin Municipal Bond Management believes any new state-imposed revenue restrictions on Texas local governments could pose a threat to investors. While other states have implemented similar restrictions, and high quality local governments in those states have successfully navigated the tax caps, we believe a number of unique factors in Texas make the restrictions concerning. These factors include significant expenditure pressures generated by explosive population growth in many cities, and the ongoing challenges many Texas obligors confront given plummeting oil and gas valuations. Our concerns are heightened given Texas cities and counties' predominant usage of limited tax debt which may result in a more challenging environment for obligors where debt payments compete for scarce resources with other municipal expenditures, presenting a more perilous scenario for bondholders. Ultimately, we anticipate that the high quality obligors held in our clients' portfolios have sufficient flexibility and reserves to mitigate any near term impacts of new revenue restrictions, however, obligors with modest reserves and rapid growth rates, or those directly impacted by collapsing oil and gas valuations may face heightened credit stress. Given that the Texas legislature may only stay in regular session for 140 days and will be gaveled to a close on June 1, 2015, and the Governor must sign or veto any legislation by June 21, we are quickly approaching the point at which it will become evident if legislation will pass this session. We will continue to diligently monitor the Legislature's activity.

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