Response to Questions on the FY 2014 Budget

Request By: Supervisors Gross/Hyland/McKay

Question: In terms of the County's Capital Improvement Program (CIP), please describe the potential impacts of an AAA downgrade by comparing Fairfax County to the Bond Buyer Index. Also discuss the potential impact of losing the tax free status of municipal bonds and the impact of Build America bonds on the CIP.

Response: **Impact of AAA downgrade by comparing Fairfax County to the Bond Buyer Index**

As the board is aware, issues surrounding the federal budget and debt concerns may also impact our AAA bond rating from the rating agencies. In the case of Moody's Investors Service, the County's bonds were put on "negative outlook" last year as a result of a new indirect linkage to the federal government based on a perceived reliance on federal expenditures and contracting. Pending any downgrade of the federal rating, Moody's has been clear that Fairfax and 4 states and 40 other localities "linked" to the federal government would also be downgraded. County staff and our financial advisors and bond counsel have been in frequent contact with the rating agencies, especially Moody's, to continue to make the case that the County's credit profile remains extremely strong.

As an example of the importance of the AAA bond rating, the County recently sold General Obligation bonds for the Series 2013A and Series 2013B at a low interest cost of 2.23%, which was one of the lowest rates recorded in recent history. This rate represented a differential of 1.16% under the Bond Buyer Index (BBI), which stood at 3.68% on the day of the sale. Further, over the last thirty years the differential between the rate on the County's bonds and the BBI has averaged 0.77%. As a result of the County's Triple A bond rating, the County has saved an estimated $580.63 million from County bond and refunding sales.

Potential Loss of the tax free status of municipal bonds

The federal tax-exemption on municipal bond interest has been in place since the income tax was enacted in 1913. This provision has led to millions of dollars invested in vital public infrastructure and has provided a tremendous amount in interest costs to state and local governments.

One of the current proposals at the federal level would place a 28% cap on the exemptions, which then imposes a 7% tax on current tax exempt interest for investors in the 35% tax bracket. For example, an individual in the 35% tax bracket earns $10,000 in interest on municipal bonds and under current policy is fully exempted from paying any taxes on this interest. However, this proposal being considered would result in an individual in the 35% tax bracket paying $700 in taxes (35% - 28% = 7%*10,000 = $700). For context, earnings of $10,000 in annual interest would equate to ownership of $500,000 in County bonds earning 2%.

On February 27, 2013, the National Association of Counties (NaCO), the U.S. Conference of Mayors (USCM), the National League of Cities (NLC), and the Government Finance Officers Association (GFOA) held a joint press conference requesting that Congress and the White House not change the tax exempt status on municipal bonds. These organizations also released a report that highlighted the broad use of bonds by municipalities across the Country and the estimated higher interest rates in the prior fiscal year if either a cap or repeal of the tax exempt status **were in place over the last fifteen years**.

The report highlighted a random sample of jurisdictions across the Country and included Fairfax County. The methodology and cost assumptions for the higher interest rates were calculated by GFOA and **not** Fairfax County and assumed the impact if the change had been made fifteen years ago. The groups projected this cost for Fairfax County for FY 2012 if either a 28% cap or repeal of the exemption were in place over the last fifteen years to be **$14.6** million and **$41.8** million, respectively. County staff projected the additional costs going forward using the same GFOA methodology for the County's five year Capital Budget assuming annual General Obligation bond sales of $275 million annually. The 28% cap equates to an additional $1.9 million in interest costs for one year or $9.6 million over five years. The repeal of the exemption equates to an additional $5.5 million for one year or $27.5 million over five years.

Further, there is **no grandfather provision** associated with either the cap or repeal of the exemption proposal, and thus would apply to bonds previously issued to investors. GFOA has strongly voiced opposition to this very significant retroactive provision on investors. Fairfax County staff strongly recommends the Board of Supervisors support the issue of maintaining the tax exemption status for Municipal Bonds. The County remains very active in the market with several programmed financings over the course of the next several years. The tax exemption provision will allow the County to continue to take advantage of its Triple A bond rating, and remain attractive to municipal bond investors. Higher interest costs incurred as a result of the loss of this exemption would ultimately be passed along to the citizens in terms of higher annual debt service costs.

Build America Bonds and the CIP

In October 2009, the County issued a $202.2 million General Obligation Bond sale for the Series 2009E (Federally Taxable) as part of the Build America Bonds (BABs) program. The BAB's component provides for annual reimbursement from the Federal Government to the County on 35% of the interest paid in a fiscal year. This translates to approximately $3 million annually or $32 million thru FY 2030 when the bonds are paid in full. These funds flow directly to the Debt Service Fund and reduce General Fund requirements for annual debt service payments. These funds have not been budgeted in the Debt Service fund pending the annual Federal payment. To-date the County has received all of the anticipated reimbursements. Additionally, there are several legislative proposals in Congress that would either revise or resurrect the BABs program. Staff will continue to monitor these issues and provide the Board of Supervisors with the necessary updates.