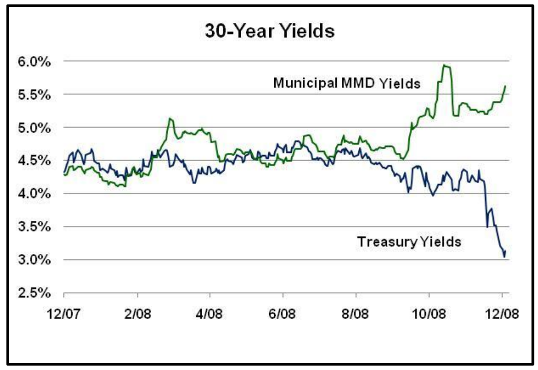
Maintaining Local Government Financial Stability and Improving Infrastructure in an Unprecedented Economic Environment

Presented to President-Elect Barack Obama's Presidential Transition Team
by The PFM Group and Representatives of Local Governments

December 16, 2008



The global credit crunch and financial system stress combined with a deepening national recession have led to an unprecedented financial environment. While problems in the tax-exempt market were not caused by the actions of state and local governments, economic circumstances have placed enormous pressure on government revenues and their balance sheets. The financial markets are not functioning effectively for municipal participants. As can be seen in the graph to the right, 30-year interest rates have increased by about 100 basis points and market demand is insufficient, forcing many governments to either cancel, postpone, or dramatically reduce the size and duration of their issuances.

The severity of this situation was reinforced by the Emergency Economic Stabilization Act (EESA), which refers to "the need to ensure stability for United States public instrumentalities, such as counties and cities that may have suffered significant increased costs or losses in the current market turmoil."[1] The legislation also empowers the Administration to "to purchase, and to make and fund commitments to purchase, troubled assets."[2]

The Cost of Inaction

State and local governments across the country are facing projected deficits in the hundreds of billions of dollars. Governments have limited tools to deal with fiscal problems and balance their budgets, and each comes with negative side effects:

- *Cut Jobs:* Governments are major employers in all communities, and cutting these jobs would worsen unemployment
- *Cut Services:* At a time when people will need more services, many public works and social programs could be eliminated
- *Raise Taxes*: Creating further economic problems
- *Borrow*: With higher debt service costs and constrained market access, affording debt service payments will become increasingly difficult

What to do: Provide Market Liquidity and Increase Credit Support.

Governments have a well-established framework for delivering services, improving infrastructure and, consequently stimulating the economy. Direct injections of cash including Federal Medical Assistance Percentage (FMAP), Community Development Block Grants (CDBG) and other direct aid measures would help to provide critical fiscal relief. However, direct aid alone will not solve the problem. Federal measures are needed to provide a catalyst for the return of a fully functioning municipal market.

In order to help state and local governments, our group recommends that the Federal government enact measures to provide increased market liquidity enabling greater access to the capital market by implementing the following:

1. **Facilitate Governments' Access to Markets** by providing Federal credit support for bond insurers, limited to municipal portfolios. A means is necessary to utilize insurers' existing credit processing infrastructure to provide credit enhancement. A Federal liquidity backstop for variable rate bonds would provide governments the ability to issue debt with lower short-term interest rates. Liquidity is essential for municipal issuers to preserve interest rate swaps and avoid the need to finance the high cost of swap termination payments rather than infrastructure improvements.
2. **Broaden the Base of Municipal Bond Investors** by passing HR 6333 or its provisions, which increase the $10 million limit for bank-qualified bonds, permit financial institutions to hold up to two percent of assets in tax-exempt securities without affecting interest expense deductions, and allow municipal issuers to refinance debt at lower interest costs, as market conditions warrant.
3. **Facilitate Governmental Funding of Liquidity:** Consider tax-exempt bond proceeds used to fund a non-profit governmental liquidity provider as "spent proceeds" as long as arbitrage earnings limitations were met.

[1] Section 103(7) of the Emergency Economic Stabilization Act (PL 110-343)
[2] Section 101 of the Emergency Economic Stabilization Act (PL 110-343)

What to do: Facilitate Infrastructure Investments

The current financial challenges manifested while public agencies were already confronting growing infrastructure needs. The American Society of Civil Engineers (ASCE) has already identified $1.6 trillion of needs over the next five years to address the condition of public infrastructure. To facilitate infrastructure investments, our group recommends the following:

1. **Eliminate the Alternative Minimum Tax** on bonds that fund all public purpose infrastructure (airports, seaports, highways) and to student loans.
2. **Increase Federal Loan Programs,** such as the Transportation Infrastructure Finance and Innovation Act (TIFIA) and the Department of Energy loan guarantee programs for power projects, and additional capitalization for clean/drinking water State Revolving Funds (SRFs), as these measures would expand lending capacity and better allow governments to fund projects while minimizing costs.
3. **Provide issuers with broader authority and greater flexibility** to leverage federal grants similar to the Grant Anticipation Revenue Vehicles (GARVEE) bonds
4. **Allow public agencies to sell an equity stake in assets** up to a certain percent (e.g. 49 percent) of capitalization without losing ability to issue tax-exempt bonds for those assets to promote Public/Private Partnerships (P3s).

Conclusion

State and local governments are confronting the dual impacts of a severe recession and a significantly deficient municipal market. The recommendations above use existing agencies and platforms to enact changes that would overcome financial market challenges, restore liquidity, lower borrowing costs and stimulate economic activity.

On December 16, 2008, The PFM Group, along with representatives from Arlington County (VA), the City of New Orleans (LA), the District of Columbia Water and Sewer Authority, the Virginia Port Authority, and Hardie Industries, inc. presented to President-Elect Barack Obama's Presidential Transition Team (PTT) on ways to maintain financial stability and improve infrastructure in an unprecedented economic environment. Jane Garvey of J.P. Morgan Securities and a member of the Presidential Transportation Transition Team also attended.

The following individuals presented to the PTT:

The PFM Group	Municipal Market Participants
John White, Chief Executive Officer	Jerry Bridges, Executive Director, Virginia Port Authority
Robert Rich, Managing Director	Ron Carlee, County Manager, Arlington County , VA
JoAnne Carter, Managing Director	Jerry Johnson, General Manager, District of Columbia Water and Sewer Authority
Robert Bobb, Director	Reginald Zeno, Finance Director, City of New Orleans
John Cape, Director	
Scott Trommer, Senior Managing Consultant	Kena Cofield, Project Manager, Hardie Industries, Inc.
Chris Pencikowski, Consultant	