Posted: 11:55 a.m. Thursday, April 25, 2013

DeVore: Texas facing a moral hazard

By Chuck DeVore

Texas Public Policy Foundation

Moral hazard is a situation where one set of people take risks but, if things go wrong, a different set of people clean up the mess.

Moral hazard is frequently the unintended result of a well-intended government program. For example, federally-chartered mortgage companies Fannie Mae and Freddie Mac, created to increase home ownership, put American taxpayers on the hook for about $238 billion in the wake of the 2008 financial crisis because they enabled banks to lend to uncreditworthy homebuyers and then flip the loans to the U.S. taxpayers.

An analogous situation is brewing in Texas.

The well-intended government program in this case is Texas' Permanent School Fund's Bond Guarantee Program, the aim of which is to reduce borrowing costs for Texas school districts by assuring lenders that they'll get their money back in the event a district faces financial difficulties. The Bond Guarantee Program has backed $53.7 billion in Texas school debt.

But this debt includes a growing portfolio of Capital Appreciation Bonds — long-term debt that may defer principle and interest payments for decades, with maturities as long as 40 years and payback ratios as high as 10-to-1. Of Texas' 1,025 school districts, 471 have issued CABs with $2.3 billion in new long-term debt over the past half-decade.

The problem with CABs is that they allow politicians, in this case local school board members, to promise the voting public that they can have great new schools without higher tax rates — while bond buyers get the assurance of having Texas taxpayers as their backstop.

Fortunately, two lawmakers, Sen. Chuy Hinojosa, D-McAllen, and Rep. Dan Flynn, R-Van, are working to head off trouble before it gets out of hand with their respective bills, SB 449 and HB 3416. These proposed laws would put reasonable limits on the issuance of Capital Appreciation Bonds, not unlike what California's Assembly passed recently but not quite as far as Michigan's outright ban in 1994.

Some school districts have been critical of bond reforms.

Leander Independent School District, just north of Austin, is the closest example. Leander is a fast growth district, with school board members facing tough decisions. How many schools should be built and how costly should they be? To what degree should portable classrooms be used to help manage construction costs? How much to borrow? What kind of debt to issue? How much to tax?

Issuing Capital Appreciation Bonds can allow school boards to avoid these tough questions, since debt repayment can be deferred and parents and students can get great new school buildings while tax rates don't have to be increased on current voters.

The Leander district now has $2.7 billion in bond debt, of which about $1.3 billion is in appreciation bonds. The maturity periods for these debt instruments are as long as 40 years.

Fitch, the bond ratings firm, downgraded the Leander district's debt a year ago, noting that they had "very high debt levels" and were paying off their debt slowly due to the use of Capital Appreciation Bonds to "minimize tax rate impacts and shift the debt burden to future taxpayers."

What Fitch didn't note was that if the Leander school district defaults, the debt burden shifts to Texas taxpayers. Thus, a "local control" issue becomes great concern to the state of Texas.

Representatives from the Leander school district came to the Capitol last week to argue against CAB reform. Among their arguments: As a fast-growth district, they had to resort to Capital Appreciation Bonds because they couldn't tax more than 50 cents per $100 of assessed property value for debt service. But, the Leander school district hasn't reached its debt limit, with board members perhaps being reluctant to ask current taxpayers to pay more while Capital Appreciation Bonds were available to delay debt payments.

Appreciation bonds allow school districts to build expensive school buildings, not raise taxes on current voters, and push the obligation to pay onto "future taxpayers" or taxpayers across Texas if they default. If ever there were a textbook case of moral hazard in Texas government, this is it.

On Other Takes: The discussion about tort reform continues.

Coming Monday: Ana Fairhust, a Texas Public Policy Foundation intern, argues for school choice. On the Balanced Views page.

Comments

If you would like to post a comment please Sign in or Register

Cancel Edit comment

4 Comment(s)
Comment(s) 1-4 of 4

- Posted by Shaqdom at 2:18 p.m. Apr. 25, 2013
- Report Abuse

THAT IS SO SCARY. Except for the fact that no school district in the history of the state has ever defaulted on a bond. Oh and except for the fact that the state can raise the local I&S tax rates to prevent a default. Oh yeah, and the state can intercept operations payments for the Foundation School Program to prevent default. AND, let's not forget schools use these bonds because the state's 50 percent limit prevent the schools from receiving financing through more preferable means. Mr. Devore has shown people the bogeyman, the sad thing is that Mr. Devore has also created the bogeyman since in reality the chance of a school bond defaulting and causing damage to the permanent school fund is close to nil. If that is truly his concern he should advocate that the 50 cent debt test be eliminated.

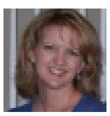
- Posted by ChuckDeVore at 5:10 p.m. Apr. 25, 2013
- Report Abuse

Shaqdom - as I outlined in my piece, Leander is not at the $0.50 limit for I&S, and yet, still resorted to overusing capital appreciation bond (CAB) debt -- so much so that the Fitch ratings agency downgraded their debt 11 months ago. Further, few lawmakers knew that the state guaranteed these long-term bonds.

- Posted by Reasonableness at 7:36 a.m. Apr. 26, 2013
- Report Abuse

"Moral hazard is frequently the unintended result of a well-intended government program."

Astute observation. "Frequently" is an understatement.



- Posted by HollyHansen at 7:51 a.m. Apr. 26, 2013
- Report Abuse

Leander ISD isn't satisfied with $2.7 billion- now they are asking for additional debt that will put them at the $4 billion mark. Is this wise? Are we not learning from the debt-ridden local governments in California that are now having to declare bankruptcy?

4 Comment(s)
Comment(s) 1-4 of 4