Coates' Canons Blog: Two-thirds Bonds

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On July 1, 2009, Carolina County had outstanding general obligation (G.O.) indebtedness of $32.2 million, revenue bond indebtedness of $7.1 million, and installment-purchase debt totaling $1.5 million. The county used its G.O. bond revenues to fund a new recreation facility and a new police department. It issued the revenue bonds to finance a major water system upgrade. And, the county used its installment-purchase financing to purchase several vehicles and other equipment, as well as to fund the renovation and expansion of some of its existing infrastructure. During the 2009-2010 fiscal year (FY 09-10) the county expended the following amounts on debt service: It retired $1.5 million in principal and $1.7 million in interest on its G.O. debt. It retired $200,000 in principal and $189,000 in interest on its revenue bonds. And, it retired $100,000 in principal and $75,000 in interest on its installment-purchase financings. Additionally, during FY 09-10, the county issued $400,000 in G.O. bond anticipation notes, $1 million in additional revenue bonds for its water system upgrade project, and $200,000 in installment-purchase financing for park land acquisition. In sum, during the FY 09-10 fiscal year, the county retired a total of $1.8 million in principal and a total of $1,964,000 in interest on its outstanding indebtedness. As of June 30, 2010, the county had $40,600,000 in total outstanding indebtedness.

Based on this information what is Carolina County's two-thirds bond capacity in FY 10-11?

a. $ 266,666

b. $1,866,666

c. $1,000,000

d. $ 733,333

What, you have no idea what two-thirds bond capacity is, let alone how it is calculated? Well then, read on…

Local Government Debt Authority

There are five basic borrowing mechanisms available to North Carolina local governments—general obligation bonds; revenue bonds; installment-purchase financings; special obligation bonds; and project development (or tax increment) financings. As I summarized in a previous **post**, the major differentiating factor among the different borrowing authorities is the primary type of security pledged as collateral for the loans.

Voter Approval Requirement for General Obligation Debt

Article V, Section 4(2) of the North Carolina Constitution requires voter approval before a local government may borrow money and secure the loan by a pledge of its faith and credit—that is, before it may borrow money secured by a pledge of its taxing power. Thus, generally, when a unit issues general obligation (G.O.) debt—pledging its taxing power as security for the borrowing—it must first obtain voter approval. (Voter approval is not required for all other authorized borrowing methods because they do not involve a pledge of a unit's taxing power.)

There are some instances, however, when voter approval is not required even if a unit issues G.O. bonds. That is because **Article V, Section 4(2)** carves out a few explicit exceptions. Specifically, it authorizes the General Assembly to exempt from voter approval G.O. debt that is issued:

(a) to fund or refund a valid existing debt;

(b) to supply an unforeseen deficiency in the revenue;

(c) to borrow in anticipation of the collection of taxes due and payable within the current fiscal year to an amount not exceeding 50 percent of such taxes;

(d) to suppress riots or insurrections;

(e) to meet emergencies immediately threatening the public health or safety, as conclusively determined in writing by the Governor; [and]

(f) for purposes authorized by general laws uniformly applicable throughout the State, to the extent of two-thirds of the amount by which the unit's outstanding indebtedness shall have been reduced during the next preceding fiscal year.

The General Assembly has authorized these exceptions to the voter approval requirement in **G.S. 159-49**. The most significant of these exceptions is (f), typically referred to as the two-thirds bonds exception.

The two-thirds bonds exception allows a local government to issue non-voted G.O. debt in an amount of up to two-thirds of the amount by which its outstanding G.O. indebtedness was reduced in the preceding fiscal year.

Calculating Two-thirds Bonds Capacity

In calculating its two-thirds bonds capacity, a local unit counts only the principal payments made on its outstanding G.O. debt in the immediately preceding fiscal year. Interest paid is irrelevant, as are principal and interest payments made on non-G.O. debt obligations (*i.e.* revenue bonds, installment-purchase financings, special obligation bonds, or project development financings). Additionally, it is not the amount of principal retired that is counted; rather, it is the net reduction in principal owed. If the local unit issues new G.O. bonds or G.O. bond anticipation notes during the fiscal year, such amounts must be subtracted from the principal reduction on the outstanding G.O. debt.

Authorized Uses of Two-thirds Bond Capacity

Of all the authorized borrowing mechanisms available to North Carolina local governments, G.O. bonds generally are the least expensive because of the strong nature of the security. But, the voter referendum requirement can pose a big hurdle to issuing this type of debt, at least in some instances. That is what makes two-thirds bonds so attractive to local governing boards. Furthermore, a local government is not restricted in any way by the purpose(s) for which the retired debt was issued. For example, although the unit in the hypothetical above issued its general obligation debt to finance the construction of new recreation and police facilities; with a few exceptions, it may use any two-thirds capacity generated from the net reduction of principal on these bonds for any authorized purpose. (**G.S. 159-48** lists the authorized purposes for which counties and municipalities may issue G.O. bonds.) By statute the General Assembly has specified that a few purposes for which G.O. debt may be issued are always subject to the voter approval requirement—auditoriums, coliseums, arenas, stadiums, civic centers, convention centers, and facilities for exhibitions, athletic and cultural events, shows, and public gatherings; art galleries, museums, art centers, and historic properties; urban redevelopment; public transportation; and cable television systems. *See* **G.S. 159-49.**

Additionally, under **G.S. 159-60**, if a local government receives a petition signed by at least 10 pecent of the unit's registered voters demanding that the proposed bond issue be submitted to the voters for approval, the unit must then hold a voter referendum, regardless of the purpose for which the two-thirds bonds will be issued. The petition must be filed with the county or municipal clerk "within 30 days after the date of publication of the bond order as introduced."

A local government's two-thirds capacity is calculated on a yearly basis. A unit must use its two-thirds amount in the fiscal year immediately following the year in which the debt was reduced. It may not accumulate its two-thirds capacity from year to year. Because of this limitation, and because of the transaction costs involved in issuing G.O. debt, typically only larger units are able to take advantage of their two-thirds bonds capacity. (In some instances, smaller units may be able to use their two-thirds debt capacity to borrow from the state, such as through the state's water infrastructure fund, because the amounts borrowed and transaction costs typically are lower.)

Loan or Gift of Credit Prohibition

There is an additional (at least potential) limitation on using a unit's two-thirds bond authority to fund certain economic development projects. **Article V, Section 4(3)** of the North Carolina Constitution bars a local government from giving or lending "its credit in aid of any person, association, or corporation, except for public purposes as authorized by general law, and unless approved by a majority of the qualified voters of the unit who vote thereon." **Section 4(5)** specifies that a loan of credit "occurs when a county, city or town, special district, or other unit, authority, or agency of local government exchanges its obligations with or in any way guarantees the debts of an individual, association, or private corporation."

The proscription on loans or gifts of credit is implicated when a unit issues non-voted debt that is secured by its taxing power. Among other things, the constitutional provision prohibits a local government from pledging its taxing power as security for a borrowing (unless the borrowing is approved by the unit's voters) and loaning the proceeds to an individual or private entity, using the proceeds to acquire stock in a private company, or (at least potentially) using the proceeds primarily to benefit an individual or private entity. Thus, although it is not entirely clear, it likely prohibits the use of non-voted G.O. debt for certain economic development projects—for example, those in which the unit borrows money to construct or acquire an asset that it then conveys or leases to an individual or private entity at less than fair market value. (This provision will be reviewed more thoroughly in a future post.)

Hypothetical Calculation

So, back to my initial question—based on the debt history described above what is Carolina County's two-thirds bond capacity in FY 10-11?

The correct answer is (d) $733,333. The county reduced the principal on its outstanding G.O. debt by $1.5 million in FY 09-10, but it also issued $400,000 in G.O. bond anticipation notes during the fiscal year. The net reduction was $1.1 million. And, two-thirds of this amount is $733,333. If you answered (a), remember that only general obligation debt is included in the calculation. If you answered (b), recall that only principal reductions are counted. And, if you answered (c), keep in mind that it is the net reduction in principal—any principal reductions must be off-set by new general obligation debt issued during the fiscal year.

Links

- www.ncga.state.nc.us/Legislation/constitution/article5.html
- www.ncga.state.nc.us/EnactedLegislation/Statutes/HTML/BySection/Chapter_159/GS_159-49.html
- www.ncga.state.nc.us/EnactedLegislation/Statutes/HTML/BySection/Chapter_159/GS_159-48.html
- www.ncga.state.nc.us/EnactedLegislation/Statutes/HTML/BySection/Chapter_159/GS_159-60.html