Municipal Debt
Frequently Asked Questions

For what reason do cities issue debt?

Cities issue debt to finance public infrastructure projects such as public facilities, parks, streets, water, sewer, and drainage improvements. Cities also issue to debt to refinance previously issued debt in order to lower the interest rate (like a home mortgage refinancing).

Do you issue debt to pay for operating expenses or to supplement your annual budget?

No. The Town does not use debt to finance operating expenses (like the Federal Government); the Town's Charter requires the Town to maintain a balanced budget.

Why do cities utilize debt instead of using cash reserves or paying for projects when the city can afford it without the use of debt?

Debt financing allow cities to finance projects, capital assets, or improvements to existing assets over their useful lives with a variety of repayment options. The tax-exempt feature of municipal debt provides a low-cost and long-term option for financing large projects on a timelier basis as compared to 'pay as you go' funding. Additionally, debt financing spreads the repayment of the debt over the useful life of the asset being financed which allows for both current and future beneficiaries to pay their 'fair share' for the public improvement/service. This also frees up money to be available to fund current services. Balance is the key.

But…looking at the Town's 2016 Audit, it says the Town has nearly $54 million in cash. Why not use this money instead of issuing debt?

The vast majority of the $54 million balance is restricted for capital improvements that are currently under construction (approximately $33 million). Additionally, the Town's existing fund balance policy requires that at least 25% of budgeted expenditures (approximately $13 million) is maintained as a cash balance to preserve liquidity and in anticipation of economic downturns or natural disasters. The majority of the remaining cash balances (approximately $7 million) are either held in restricted accounts or are encumbered for specific purposes.

What, if any, are the alternatives to issuing debt?

- *<u>Cities could use available cash reserves</u> (e.g. utilize existing fund balances) to fund projects. When using cash reserves, there could be potential negative credit implications as well as cash flow concerns if the fund balance is greatly depleted.*
- *<u>Cities could defer or abandon the purchases/improvements</u>. This too could have potentially negative credit implications as it could deter taxable value growth and it could cost the city more in long run in the form of lost assessed valuation or economic development.*
- *<u>Cities could use 'pay-as-you-go' financing</u>. 'Pay-as-you-go' financing uses current revenues to generate excess cash through additional taxes and/or user fees to 'save up' over several years for a future project.*
    - *It could be difficult to apply this method of financing to large projects due to the inability to have necessary funds on hand to enter into the construction contract.*
    - *It puts the majority of the cost on a current user, and not a future user, for an asset that has a useful life over several decades*
    - *For example, in order to raise $1 million on $4.5 billion tax base, Addison would have a one-time $0.022 tax rate increase. Alternatively, raising $1 million through the issuance of 20-year bonds results in $0.0016 tax rate over a 20-year period.*
    - *Implementation of 'pay-as-you-go' financing could result in wide tax rate fluctuations when the Town needed to levy additional taxes to pay lump sum payments for major projects.*

How are cities able to issue debt?

Cities have specific authority provided by the State Constitution to issue debt instruments in order to finance public improvements.

How is debt repaid?

Tax supported debt is repaid by the on-going collection of tax revenues. The Town has two components to its tax rate: the Maintenance and Operations component which pays the costs of operating the Town, and the Interest & Sinking Fund component which can only be used to pay the current annual debt service requirement. Revenue supported debt is paid by the user fees of the specific revenue source (water and sewer, hotel/motel occupancy taxes, etc.)

The Town has historically issued 20 year bonds. Does this mean that short-lived assets are also financed over 20 years?

No. Even though one bond issue may be utilized, short-lived assets are financed over the term of their useful lives and accounted for separately even within a single bond issue.

How is municipal debt different from my personal debt?

Municipal debt, by definition, is not entirely different than a home mortgage debt: you pay an annual principal and interest component based on a set repayment schedule based on a fixed interest rate. Personal debt is generally prepayable at any time, however, investors of municipal debt want income certainty so typically municipal debt is not prepayable until 10 years after the issuance date.

I would like to be debt free by the time I retire. Is the Town ever going to be debt free?

The approach to debt by a person is different from the approach to debt by a municipality. While most individuals would like to be debt free, especially as they enter retirement, cities, on the other hand, exist into perpetuity and never retire. As a city grows, so does its gross domestic product or GDP (financial resources) and its population. For the benefit of the city's current and future residents, new infrastructure must be built, and older infrastructure must be repaired and maintained. Cities own all the assets and infrastructure and must maintain them and provide for service(s) accordingly.

What is our current debt service tax rate, our total tax rate?

Addison's current tax rate is $0.55. The debt service tax rate component (also referred to as Interest and Sinking- I&S) is $0.153042 and the Maintenance and Operations (M&0) component is $0.396958.

How much debt can we sell at our current tax rate, what assumptions are you using?

The Town has a total debt capacity of $61,160,000 over 10 years based on the <u>existing</u> I&S tax rate of $0.153042. However, Addison already has $32 million committed in General Obligation bonds and Certificates of Obligation. This means that either voters have approved bonds that have yet to be sold and/or Council has committed to fund future projects through other debt instruments. These commitments are encumbrances against the Town's $61 million debt capacity. After subtracting those encumbrances, the Town's remaining tax-supported capacity is $29,160,000.

Assumptions: 4.1% annual taxable assessed valuation growth for 10 years with no growth thereafter (as provided by Town officials), 20-year level annual debt service at 4.00% in 2018, 4.50% in 2019 and 5% thereafter, and current debt service tax rate of $0.153042.

If we sell the bonds will my tax rate increase, how much?

All things being equal, the tax rate will not change as long as the Town does not exceed its 2017 debt capacity. However, there are a variety of other factors that can impact the tax rate.