

spotlight

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COPs EVADE VOTER SCRUTINY

Taxpayers on the hook for special indebtedness

KEY FACTS: • The last statewide General Obligation Bond referendum was held in 2000; all debt since then has been issued without voter approval, making special indebtedness the sole form of debt in North Carolina since 2001.

- Special Indebtedness is more expensive than traditional General Obligation debt, thus creating a larger burden on taxpayers.
- 40% of North Carolina's total current debt is special indebtedness.
- Certificates of Participation (COPs) are the most favored form of special indebtedness.

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north Carolina, like any other state or municipality, issues debt or bonds to pay for specific projects. These bonds are essentially promises and are commonly called general obligation or ‘GO’ bonds. Simply put, an investor purchases a bond from North Carolina, and the state uses the money to fund its desired project. The investor will receive the purchase amount plus interest once the bond reaches its maturity date and will usually collect interest payments over time on scheduled interest payment dates. GO bonds are issued with the promise that the government will repay its debt obligation through taxation or revenue from projects thus making it a general obligation of the people.

The use of GO bonds and other debt instruments is outlined in the North Carolina Constitution, which says, “*The General Assembly shall have no power to contract debts secured by a pledge of the faith and credit of the State, unless approved by a majority of the qualified voters of the State who vote thereon.*”¹ This plainly says that the state of North Carolina must hold a referendum before it can issue debt; no new general obligation bonds have been issued statewide since 2000. The reason for this is that a new type of debt was created to bypass the constitution and the voters - special indebtedness.

Special Indebtedness

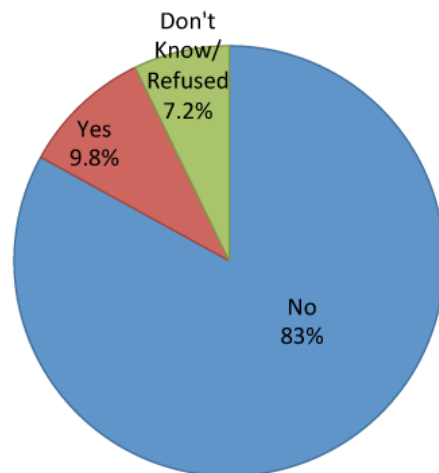
The 2003 budget legislation included the State Facilities Finance Act, where special indebtedness and the specifics of new debt vehicles included under that umbrella term are explained. The three forms of special indebtedness created are certificates of participation, lease purchase revenue bonds, and limited obligation bonds. The creation of these appropriation-funded debt vehicles gave legislators a method to issue non-voter approved debt, and over time have become the sole method for North Carolina’s debt issuance. Their creation was prompted by the necessity for alternative financing methods to allow more flexibility and the ability to take advantage of changing financial and economic environments. In the budget document, it was confirmed the state would continue to issue debt through general obligation bonds, which has not happened, and there was no rule introduced for accountability or transparency.

As is the case for all bonds, the affordability is determined by the method through which it is repaid to investors and the strength of the promise. GO debt traditionally has a very low interest rate because it is secured by the full faith, credit, and taxing power of the state. Special indebtedness is repaid by an annual debt service appropriation from the General Fund, thus carrying a higher interest rate than GO debt. The more risky investment for the bondholders is the reasoning for the higher interest rate, which translates into increased costs for projects being financed with special indebtedness and a higher bill to taxpayers.

Certificates of Participation

This form of special indebtedness has been the most popular of the debt instruments created in the State Capital Facilities Act and is the source of the catchphrase ‘COPs.’ COPs are a specialized form of lease-purchase contract for the acquisition or construction of equipment, land, or facilities. They resemble bonds yet are sold as securities. In theory, the certificate holder could foreclose on the equipment or facility financed if default ever occurred, even though this has never happened.

Should the North Carolina state government be allowed to issue new debt without voter approval?



Source: NC Civitas Institute, March 2012 Poll, Question 10

The majority of North Carolina's first issuances of special indebtedness were COPs, amounting to \$300 million during the 2003-2004 fiscal year. This money was to be used for the repair and renovation of state facilities, and over 500 projects were selected, mainly in justice and public safety and health and human services. By 2008, outstanding COPs totaled almost \$1 billion. Over time COPs have become the most popular and preferred financing methods, because they can be issued more quickly than referendum bonds. Today COPs are used to finance other entities, such as the UNC system, and there is a current outstanding balance of \$512.9 million. (See Appendix 1.)

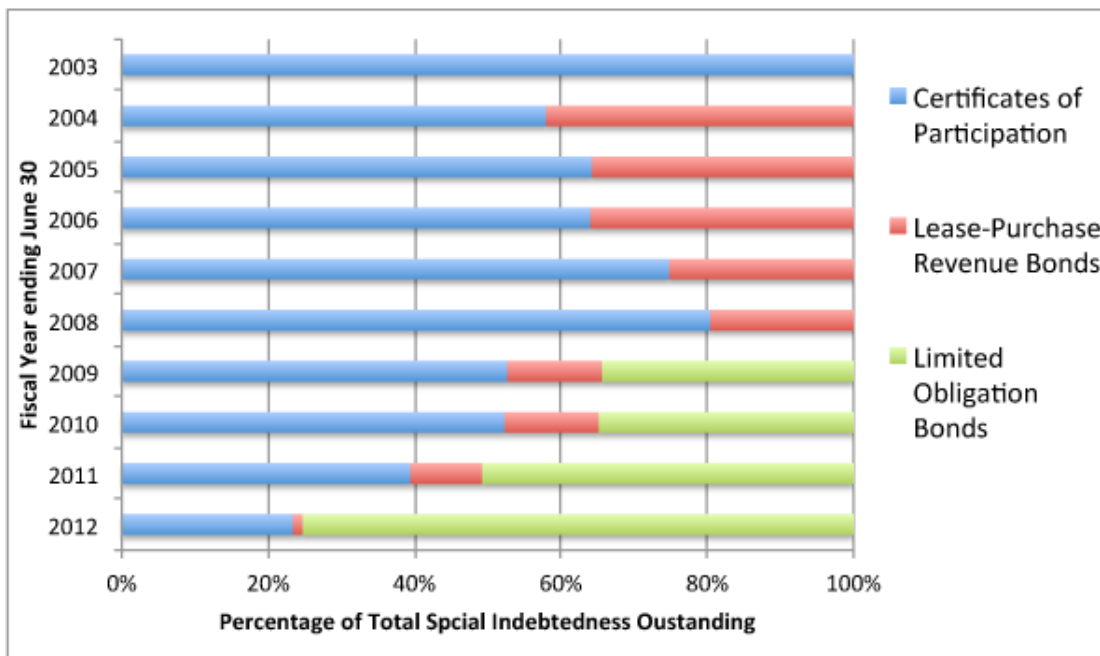
Lease Purchase Revenue Bonds

This form of debt is a financing method used for local governments to acquire real property or personal property by paying for the use and acquisition of the property through renewable contracts. Lease purchase revenue bonds were used to purchase three close-security correctional facilities located in Alexander, Anson, and Scotland counties in 2003 and two additional facilities in Avery and Pamlico counties in 2004. These initial purchases were for \$272 million and there is now an outstanding balance of \$20.9 million.

Limited Obligation Bonds

The first issuances of limited obligation bonds were in 2008, and they have since become the second most popular form of special indebtedness behind COPs. They operate as typical bonds and have the flexibility to be issued with varying maturity dates as either serial^a or term^b bonds. The only restriction is that none may mature more than 40 years after their issue dates. The current outstanding debt from this form of special indebtedness is \$2 billion from funding projects such as those at the NC Zoo, Universities, DHHS, and the Art Museum.

Chart 1: Special Indebtedness Outstanding By Type



a Serial bonds are issued on the same date and are quoted by their yield, as opposed to their price. There are various maturity schedules at regular intervals until the issue is retired.

b Term bonds are from the same issue and share the same maturity dates. Many have a call feature that can be redeemed at an earlier date than the other issued bonds.

Cost Differences

GO bonds are paid through the taxing power of the state. As a result, investors face very little chance of default. Special Indebtedness, on the other hand, is sometimes issued on an unsecured basis, for example by using a specific stream of revenue or a lease payment or financing agreement. All state operations are paid for through the General Fund, including appropriation-funded debt such as special indebtedness. Depending on economic fluctuations in state revenue, the state has more chance of default on these special indebtedness loan repayments thus making this form of debt more risky and worthy of a higher interest rate to investors.

Due to the risk in fluctuating market conditions, interest rates for both special indebtedness and GO bonds change over time. For example, in 2002 there were public improvement GO bonds issued with an interest rate categorized as “variable to 18%.”² Since then interest rates have dropped significantly due to the 2008 recession, and GO bonds issued in latter years have hovered around the 5% mark. When doing a direct comparison between appropriation-supported debt and GO bonds, the former is more expensive to finance than the latter. While this doesn’t sound like a large amount of money, given an overall state budget of around \$50 billion, this interest rate penalty does increase the cost of the projects being financed and over time amounts to a significant portion of the debt.

Table 1: Authorized Special Indebtedness in North Carolina, Interest Differential Over GO Debt³

	Authorized Special Indebtedness	Estimated Additional Interest Incurred Due To Use Of Special Indebtedness Rather Than GO Debt
2005	\$297,100,000	\$10,101,400
2006	\$760,300,000	\$25,850,200
2007	\$1,252,300,000	\$42,578,200
2008	\$1,908,200,000	\$64,878,800
2009	\$1,412,000,000	\$48,008,000
2010	\$1,600,000,000	\$54,400,000
2011	\$456,000,000	\$15,504,000
Total	\$7,685,900,000	\$261,320,600

Author’s calculations were based upon NC Treasurer’s office bond scenarios with interest rate differential of 25 basis points. On average, the approximate increase in interest paid over the life was \$3.4 million on \$100 million par. Note this is the estimated difference in interest rates between GO and non-GO debt at the current time and is subject to market conditions. It should not be considered a fixed amount.

Why not remove the State Facilities Finance Act?

Each year the Treasurer’s Office publishes a Debt Affordability Study that outlines all the state’s debt and the stability of the state in payment of that debt. Beginning in 2007, the study recommended the state issue a different form of debt than special indebtedness. Prior to 2001, the state only issued GO debt, yet since then the sole reliance has been on non-GO debt vehicles. Over time the state has learned from the experience of other states that exclusive use of GO debt is not necessary, but the state should consider authorizing GO debt as the preferred type and continue in moderation with other forms such as special indebtedness.

A repeal of the State Facilities Finance Act is not a viable solution to the problem of massive non-voter approved debt. The removal of these debt vehicles would be viewed negatively by the financial markets, and could

send investors a signal that North Carolina no longer endorses appropriation funding for debt-financed projects. This domino contagion would negatively affect the value of the outstanding special indebtedness held by investors and possibly lower the state’s bond ratings or trigger other unintended consequences.

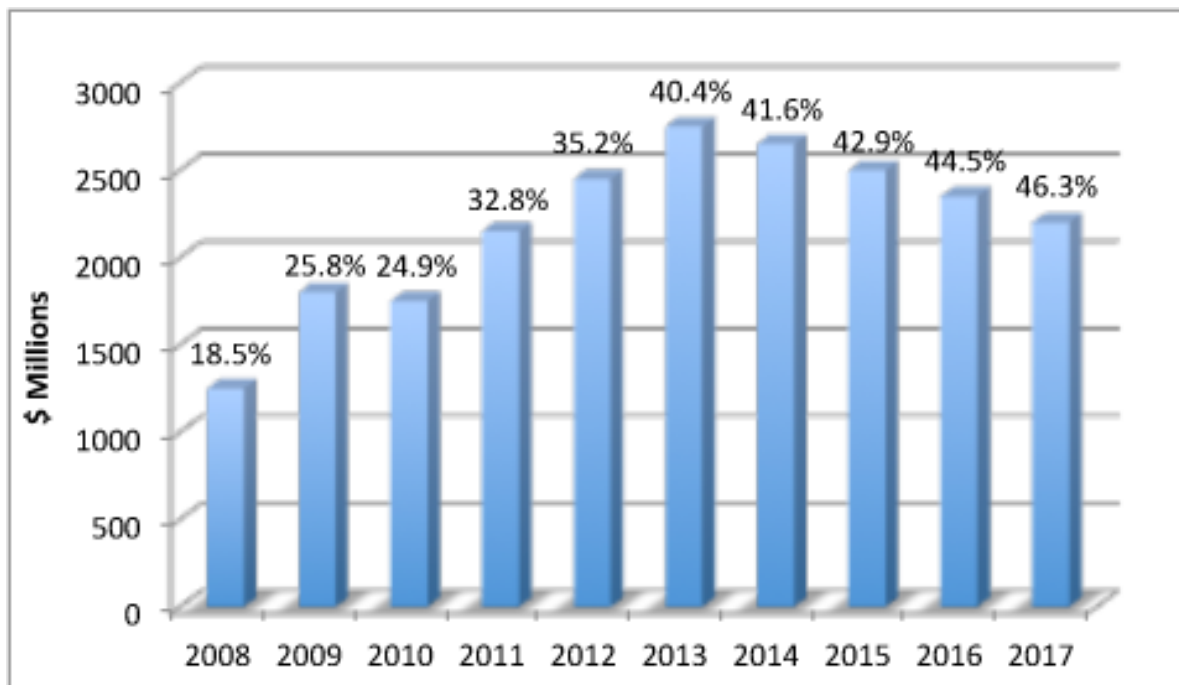
Legislation

Special indebtedness was created in the 2003 budget legislation through the State Capital Facilities Finance Act. Since then, the only major legislation to change the act has been a technical corrections bill in 2007, which repealed of one of the sections. The section removed would have created a fourth form of special indebtedness called Real Estate Certificates of Participation (RECOP). No forms of this debt were issued and the repeal did not affect any other portion of the original act.

In more recent history, legislation was introduced during the 2011 session to completely remove special indebtedness and require all debt to be approved by voters through a referendum. It did not get much attention because of the fear that complete elimination would have negatively affected North Carolina’s bond ratings. The General Assembly did partially address the issue by canceling \$232.4 million in special indebtedness under the Debt Reduction Act of 2011. This cancellation included all special indebtedness authorized in 2010.

This year a bill has been introduced that has created some discussion among lawmakers and has more support than the prior. The bill does not eliminate special indebtedness all together, but limits the amount of special indebtedness North Carolina may have outstanding at any one time. Special indebtedness makes up about 40% of North Carolina’s total outstanding debt. This bill would cap that amount at 25% after July 1st. If this bill is signed into law, no more special indebtedness can be used until the percentage drops below 25%; in essence there is chance a temporary moratorium on special indebtedness will occur saving taxpayers valuable dollars. The General Assembly should ultimately do away with special indebtedness altogether, but this is a good first step in the right direction.

Table 2: Special Indebtedness Outstanding⁴



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End notes

1. Article 5, Section 3 of the North Carolina Constitution
2. Public Improvement Series 2002D, 2002E, 2002F, 2002G issued 5/1/02, Ch.631, 1995 session law and Ch. 3 2000 session law
3. North Carolina Debt Affordability Study 2013, page 8
4. North Carolina Debt Affordability Study 2013, page 14

Appendix 1: COPs & Lease Purchase Revenue (LPR) Bonds (\$ millions)

	2003A COPs	2003 LPR	2004 LPR	2004A COPs	2004 R&R COPs	2006A R&R COPs	2007B R&R COPs	2005A COPs	2006A COPs	2007A COPs
Projects Funded with Special Indebtedness										
Eastern & Western Wildlife Centers (SL 200-143)	17.5									
NC Correctional Facilities (Alexander, Anson & Scotland) (SL 2001-84)		218.4								
NC Correctional Facilities (Greene & Bertie) (SL 2001-84)				159						
NC Correctional Facilities (Avery & Pamlico) (SL 2001-84)			53.6							
Repairs and Renovations across State/UNC SYS (2003-284)					125	100	75			
SL 2003-284, 2003-314, 2006-66 & 2006-231										
Prison #6 Columbus County (SL 2003-284)								48.6	16.5	33
Psychiatric Hospital (SL 2003-314)								57.2	60	12.8
Art Museum Expansion (SL 2006-66)									13.1	4.8
DHHS-State Lab for Public Health (SL-2006-66)									2.4	2.7
ITS-Backup Data Center (SL-2006-66)									21.1	2.7
DHHS-Eastern Region Psychiatric Hosp (SL 2006-66)									2.8	2.1
UNCC-Center City Classroom (SL 2006-66)									1	0.8
DOC-Regional Medical/Mental Health Cnt (SL 2006-66)									8.1	3
Wildlife Resources Gamelands (SL 2006-231)									10	10
Downtown Raleigh Parking Deck (SL 2006-231)									3	3.7
Total: SL 2003-284, 2003-314, 2006-66 & 2006-231								105.8	138	75.6
SL 2004-179 (HB-1264) (1/2 TTF/1/2H&W TF)										
Youth Development Centers								12.2	8	15
UNCC Bioinformatics								2.1	3.5	10.7
UNC Cancer Center								18	22.5	54.1
Cardiovascular Center (ECU)								22.5		22.3
Pharmacy School (ECSU)								2.3	0.5	3.3
Health Center (UNCA)								2.8	1	9.5
Nursing Center (UNCP)									3	0.9
Milennial Campus (NCA&T / UNCG)									0.5	1.5
UNCP Nursing School									2.5	0.1
Health Center-Western (WCU)									1.5	
Design Centers (WSSU / NCSA)									0.5	3.3
Total SL 2004-179 (HB 1264)								59.9	43.5	120.6
Parks, Recreation and Preservation of Natural Heritage Projects (PRTF & NHTF) (SL 2004-179)								22.7	18.5	3.8
Total Financing Requirements:								188.4	200	200
Special Indebtedness Balances at February 28, 2013	1	8.1	12.8	15.9	18	70	60	49.8	140	176
General Obligation Bond Balance at February 28, 2013	4,413.3									

Appendix 2: Limited Obligation Bonds (\$ millions)

	2008 A	2009 A	2011 A	2011 B*	2011 C	2013 A
Projects Funded with Special Indebtedness						
SL 2003-284, 2003-314, 2006-66 & 2006-231						
Art Museum Expansion (SL 2006-66)	8.5	14.9				
DHHS-State Lab for Public Health (SL-2006-66)		16.6			44.9	13.8
DHHS-Eastern Region Psychiatric Hosp (SL 2006-66)	8.5	0.8	23.1		37.6	27
UNCC-Center City Classroom (SL 2006-66)	0.5	0.4	32.1		6.3	
DHHS-Western Region Psychiatric Facility (SL 2006-66)	3		12.2		70.1	
DOC-Regional Medical/Mental Health Cnt (SL 2006-66)		18.4	45.1		3.8	22.8
Downtown Raleigh Parking Deck (SL 2006-231)	7.1	_____	1.6		0.1	_____
Total: SL 2003-284, 2003-314, 2006-66 & 2006-231	27.6	51.1	114.1		162.7	63.6
SL 2007-323						
ASU College of Education Building	5.2	4.5	9.2		7.1	
FSU Science and Technology Complex	0.8		7.2		2.1	9
NCSA Library	0.6				1.3	14
NCSU RB Terry Animal Hospital	12.2	13.2				
NCSU Engineering III Building	13.4		5.1		0.7	
UNCA Rhoades Hall and Tower Renovations	0.1	0.2	4.6		0.7	
UNCCH Genomics Sciences Building		19.1	44.6		8.6	
UNCW Teaching Laboratory Building**	3.1					8.5
WCU Health and Gerontological Sciences Bldg	0.4	1.6	8.6		4.7	3.3
WSSU Student Activities Center		0.2	3.1		15.9	6
Nonoscience & Nanoengineering Bldgs	0.7	0.6	36.9		7.1	2.5
UNCGA Coastal Studies	4.7		0.7		21.5	2
DOC Nursing Medium Security Addition (Scotland)	3.5	3.1	1			0.3
DOC Alexander Minimum Security Addition	1.5	4	1.3		1.5	
DCR Tryon Palace History Education Center	5	8.1	7.1			
DENR State Conservation Land Acquisition (PRTF & NHTF)	25	95	_____		_____	_____
Total SL 2007-323 Projects	76.2	149.4	129.5		71.2	45.6
SL 2008-107						
ECU-School of Dentistry					28.1	11
ESU-Family Medicine Facility			10.2		1.5	
ECSU-School of ED		0.2	9.4		3.5	
NCA&T-Horse Park						
NCA&T-General Classroom Building		4.8	4.5		0.8	
NCCU-School of Nursing		0.6	15.7		2.3	
NC School of Arts-Storage Facility			0.2		1	3
NC School of Arts-Film Production Facility			0.2		2.5	4.5
NCSU Centennial Campus Library		0.4	41.9		25.7	22.7
NCSU -4H Camps		1.6	0.8		0.1	
UNCCH-School of Dentistry Addition		0.7	34.2		6.5	
UNCC-Energy Production Infrastructure			26.2		7.4	9
* 2011B are Special Indebtedness Refunding Limited Obligation Bonds (Refinanced Portions of: 2003A \$10.7 million, 2004A \$71.5 million, 2004B R&R \$59 million, 2004LPR \$24.9 million & 2005A \$77.2 million)						

	2008 A	2009 A	2011 A	2011 B*	2011 C	2013 A
UNCG-Academic Classroom & Office		3.1	4.3		8.3	1.1
UNC-System Fire Sprinklers		3.4	1.7		0.2	
UNC-System Land *		10				
DOJ-State Judicial Facilities		34				
DOC-Women's Health Facility		7	1.1			4
DOC-Addition to Scotland		1.2	1.5		0.4	
DOC-Addition to Bertie		2.3	3.3		2.5	
DOC-Addition to Tabor		1.9			7.2	
DOC-Addition Lanesboro		0.7	2.7		1	3.9
CSS Nurse Phase I					1.8	
Ports MC and Wilmington Improvements		5.2				
SENC Agricultural Center Pavilion		0.1	2.7		0.8	
Agriculture-WWNC Farmer's Market Improv		0.03	0.5		0.1	
Agriculture-Davis Arena Expansion		0.2	4.2		2.3	
Oyster Hatchery		2.3				
NC Zoo-Polar Bear		0.2	0.7			0.1
Land for Tomorrow *		10	---		---	---
Total SL 2008-107 Projects:		89.9	166		104	59.3
SL 2004-179 (HB-1264) (1/2 TTF/1/2H&W TF)						
UNCC Bioinformatics	5.9	10.8				
UNC Cancer Center	52.6	32.1				
Cardiovascular Center (ECU)	12.9	2.4				
Pharmacy School (ECSU)	13		1.1		0.1	
Health Center (UNCA)		1.5	3.7		1.9	
Nursing Center (UNCP)		0.1	0.7		1.7	
Millennial Campus (NCA&T / UNCG)	2.9					
UNCP Nursing School	0.4	16.2	8.1		1	
Health Center-Western (WCU)	6.8		0.4		0.1	
Design Centers (WSSU / NCSA)	1.6	0.5	2.6		2.9	
Total SL 2004-179 (HB 1264)	96.2	63.5	16.5		7.8	
Parks, Recreation and Preservation of Natural Heritage Projects (PRTF & NHTF) (SL 2004-179)						
Maury Correctional Facility (SL 2009-451)			6		3.9	4
Green Square Project (SL 2009-209)		40	10.2		7.5	12
BRIC Project (SL 2009-209)		6	40		26.6	60
Repairs and Renovations (2009-209)			17.5		16.4	5.6
Total Financing Requirements:	200	400	500		400	250
Limited Obligation Bonds' Balances at February 28, 2013	180.9	359.1	487.7	367.4	400	250
General Obligation Bond Balance at February 28, 2013	4,413.3					

* 2011B are Special Indebtedness Refunding Limited Obligation Bonds (Refinanced Portions of: 2003A \$10.7 million, 2004A \$71.5 million, 2004B R&R \$59 million, 2004LPR \$24.9 million & 2005A \$77.2 million)