



State Tax Cuts and Debt Market Outcomes: An Empirical Analysis of the Kansas Tax Reform (Dzigbede and Pathak)

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FitchRatings



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Overview



- Stated Goal of Authors:

To examine the extent to which state tax cuts affect borrowing costs and credit ratings of state and local governments, using the Kansas example.

To the author's knowledge, this study is among the first efforts to examine, directly, the impact of state tax cuts on state and local debt markets.

- Authors looked at borrowing costs for states and locals and also analyzed credit ratings for local governments.

- Findings:

Mixed impacts on state government borrowing costs

Adverse impact on local government issuers



- Authors controlled for several variables that are known to affect borrowing costs:

Bond size

Bond maturity

Tax exemption

Method of sale (competitive or negotiated)

Callability

Bond Buyer General Obligation Bond Index



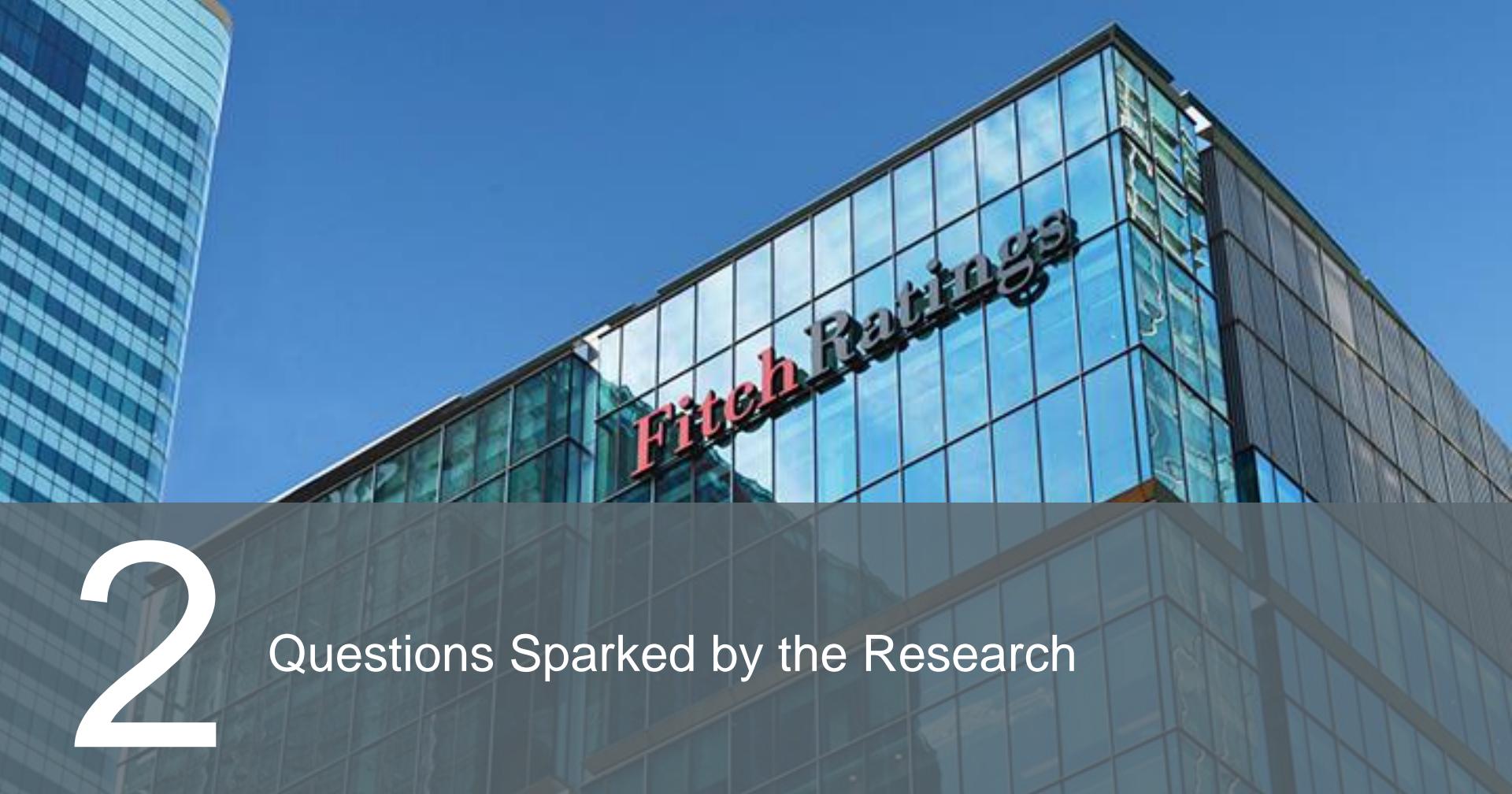
- Challenges in Analysis:

State sample size is relatively small

Legal and institutional constraints on debt issuance and borrowing practices vary considerably by state

Results can be skewed by tax changes occurring at different times in different states

Federal action or other events can overwhelm other factors

A photograph of a modern skyscraper with a glass facade. The words "Fitch Ratings" are written in red and green on the upper left portion of the building. The sky is clear and blue.

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Questions Sparked by the Research



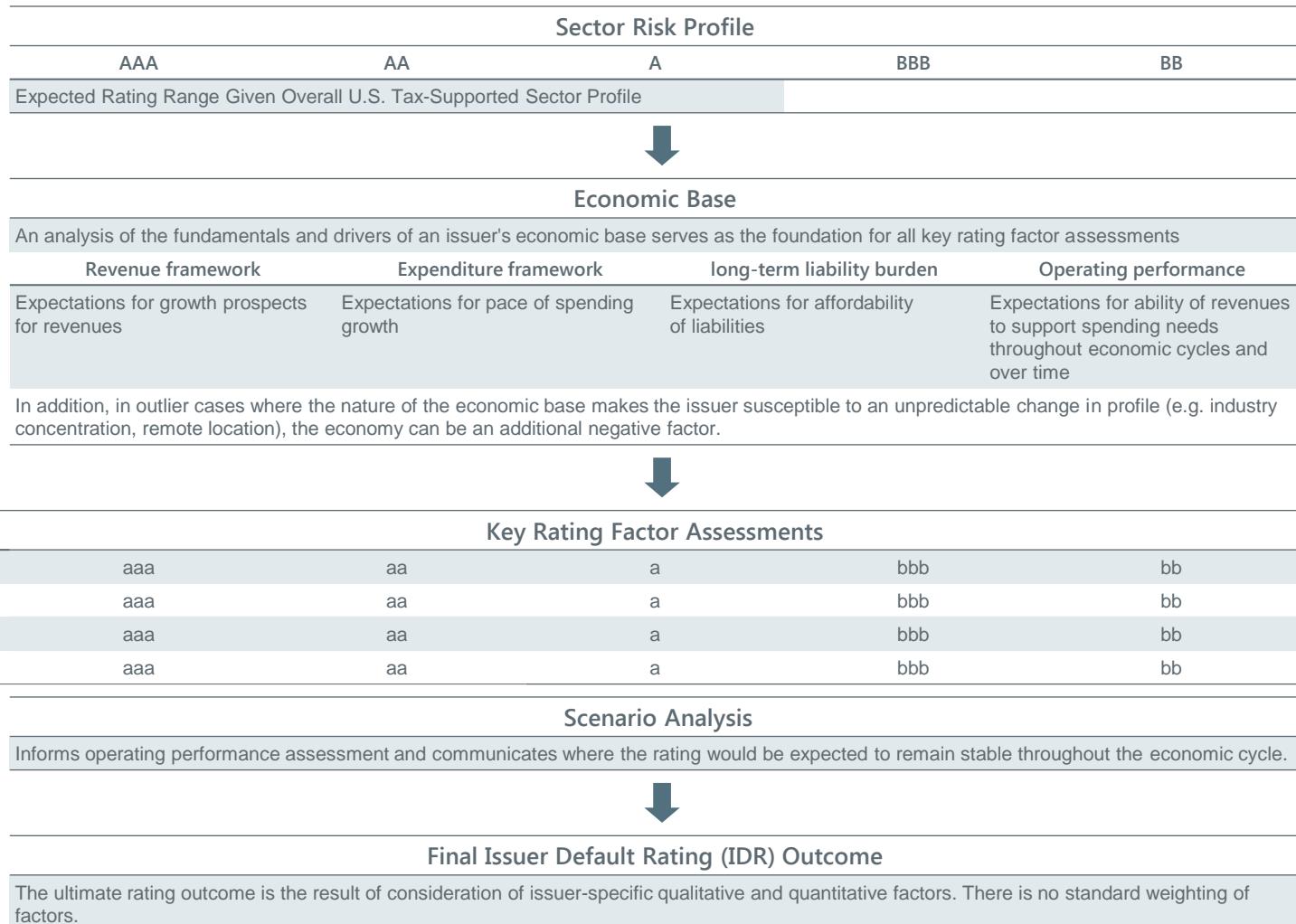
1. How are tax cuts considered in the evaluation of municipal credit quality?

Are they a clear credit negative from an analyst's perspective?

From Fitch's perspective, the significance of tax cuts as a credit factor depends on the context, and cuts are often a policy rather than a fundamental credit quality question.

The key focus is on sustainability.

Overview of Fitch's Issuer Default Rating Framework



Source: Fitch



- Fitch's focus is on forward-looking expectations rather than point-in-time assessments.
- Fitch expects a government's performance to vary, potentially considerably, throughout an economic cycle.
- Fitch's overarching philosophy is that ratings should not change due to normal cyclical variations, so it is only an economic cycle of unusual depth or duration that would be expected to result in a higher level of rating transition.
- To support this rating approach, Fitch's scenario analysis considers issuer-specific fundamentals and potential performance under a standard economic stress, highlighting how cycles affect individual issuers differently.

Overview of Fitch's Issuer Default Rating Framework



Local Government Scenario Analysis

Yellow cells allow user input/override

Select an issuer:

Scenario Parameters:	Year 1	Year 2	Year 3
GDP Assumption (% Change)	-1.0%	0.5%	2.0%
Inflation Assumption (% Change)	2.0%	2.0%	2.0%
Revenue Output (% Change)	-3.0%	1.0%	4.0%
Inherent Budget Flexibility:	Midrange		

Analyst Interpretation of Scenario Results:

[If applicable, discuss factors embedded in the historical data that make the scenario appear materially more/less severe than baseline trends would dictate. For all, discuss analyst's expectations for how the issuer is likely to respond in the (baseline trend) scenario. These expectations should (1) be consistent with prior assessments of revenue and expenditure flexibility and (2) serve as the basis for the assessment of Financial Resilience Through Downturns.]

Reserve Safety Margin in an Unaddressed Stress

Actual | Scenario

Available Fund Balance

Scenario Ratings: aaa, aa, a, bb

Scenario:	aaa	aa	a	bb
2008	22%			
2009	24%			
2010	26%			
2011	35%			
2012	32%			
2013	31%			
2014	30%			
Year 1	28%			
Year 2	25%			
Year 3	18%			

Financial Resilience Subfactor Assessment:

Revenues, Expenditures, and Fund Balance	Actuals:							Scenario Output:		
	2008	2009	2010	2011	2012	2013	2014	Year 1	Year 2	Year 3
Total Revenues	66,634	67,543	67,104	73,195	75,057	76,154	79,139	76,765	77,532	80,634
% Change in Revenues	1.4%	-0.6%	9.1%	2.5%	1.5%	3.9%	-3.0%	1.0%	4.0%	
Total Expenditures	65,894	68,749	66,324	67,336	69,053	74,325	76,056	77,577	79,129	80,711
% Change in Expenditures	4.3%	-3.5%	1.5%	2.5%	7.6%	2.3%	2.0%	2.0%	2.0%	
Transfers In and Other Sources	2,397	2,408	2,186	2,943	2,427	2,974	3,060	2,968	2,998	3,118
Transfers Out and Other Uses	2,813	1,646	1,671	2,281	7,806	5,269	5,505	5,615	5,727	5,842
Net Transfers	-416	762	515	662	-5,379	-2,295	-2,445	-2,647	-2,730	-2,724
Bond Proceeds and Other One-Time Uses	0	0	0	0	0	0	0	0	0	0
Net Operating Surplus(+) / Deficit(-) After Transfers	324	-444	1,295	6,521	625	-466	638	-3,459	-4,326	-2,802
Net Operating Surplus(+) / Deficit(-) (% of Expend. and Transfers Out)	0.5%	-0.6%	1.9%	9.4%	0.8%	-0.6%	0.8%	-4.2%	-5.1%	-3.2%
Available Fund Balance (General Fund)	15,372	16,683	17,772	25,097	25,712	25,212	25,856	22,397	18,071	15,269
Other Available Funds (Analyst Input)										
Combined Available Funds Balance (GF + Analyst Input)	15,372	16,683	17,772	25,097	25,712	25,212	25,856	22,397	18,071	15,269
Combined Available Fund Bal. (% of Expend. and Transfers Out)	22.4%	23.7%	26.1%	36.1%	33.5%	31.7%	31.7%	26.9%	21.3%	17.6%

Reserve Safety Margins	Inherent Budget Flexibility:				
	Minimal	Limited	Midrange	High	Superior
Reserve Safety Margin (aaa)	48.0%	24.0%	15.0%	9.0%	6.0%
Reserve Safety Margin (aa)	36.0%	18.0%	12.0%	7.5%	4.5%
Reserve Safety Margin (a)	24.0%	12.0%	7.5%	4.5%	3.0%
Reserve Safety Margin (bbb)	9.0%	6.0%	4.5%	3.0%	2.0%

Notes: Scenario analysis represents an unaddressed stress on issuer finances. Fitch's downturn scenario assumes a -1.0% GDP decline in the first year, followed by 0.5% and 2.0% GDP growth in Years 2 and 3, respectively. Expenditures are assumed to grow at a 2.0% rate of inflation. Inherent budget flexibility is the analyst's assessment of the issuer's ability to deal with fiscal stress through tax and spending policy choices, and determines the multiples used to calculate the reserve safety margin. For further details, please see Fitch's US Tax-Supported Rating Criteria.



2. If tax cuts are enacted with the expectation that they will spur economic growth, how long does the market give the government to let this materialize?

From Fitch's perspective, U.S. municipal market analysts do not give much credit to hoped-for economic stimulus from tax cuts.

The research on the economic benefits of tax cuts is inconclusive, while the immediate fiscal impact is much more clear and tends to be the focus.



3. How does action on the state level affect local governments in ways that show up in borrowing costs and credit ratings?

Does the impact vary by type of local government based on the nature of the fiscal relationship with the state, if any?

Is the impact reflective of reality or perception?



4. Beyond fundamental credit considerations, what are some of the other things that affect bond pricing?

- Overall market factors
- General municipal supply/demand
- Demand for tax-exempt paper of an individual state (affected by state wealth and tax rates and supply)
- Headline risk
- Changes in methodologies/criteria



5. What is the best comparison group of states for the Kansas analysis?

Authors select four neighboring states (Oklahoma, Colorado, Missouri, and Nebraska) because they are “geographically proximate, politically comparable, and compete for economic activity against each other.”



6. What is the appropriate local role in state policymaking?

Authors raise the question of whether local government policymakers should have a more prominent voice in state tax policymaking.

This is a time of interesting questions on fiscal federalism, and this research adds another element to the discussion.

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Possible Areas for Future Research



- Try to incorporate the varying fiscal context for tax cuts – policy decision vs. causing near-term fiscal disruption
- Do a comparative analysis with other states that did significant tax cuts to consider whether there is a line at which the magnitude of the cuts becomes significant to debt market outcomes
- Explore what impact, if any, the reversal of the tax cuts in Kansas has had
- Dig deeper into the experience of different types of local governments in Kansas to see if results vary by type of government
- Look at how local finances were affected by the Kansas state tax cuts to determine if debt market outcomes reflected a real or perceived impact
- Analyze the debt market reaction to tax cuts in states that manage tax rates up and down throughout the economic cycle
- Examine whether the types of taxes being cut affects the debt market outcomes

Possible Areas for Future Research



- Potential sources of additional information to support research:
 - National Conference of State Legislatures (NCSL)
 - National Association of State Budget Officers (NASBO)
 - Municipal Securities Rulemaking Board (MSRB) EMMA website

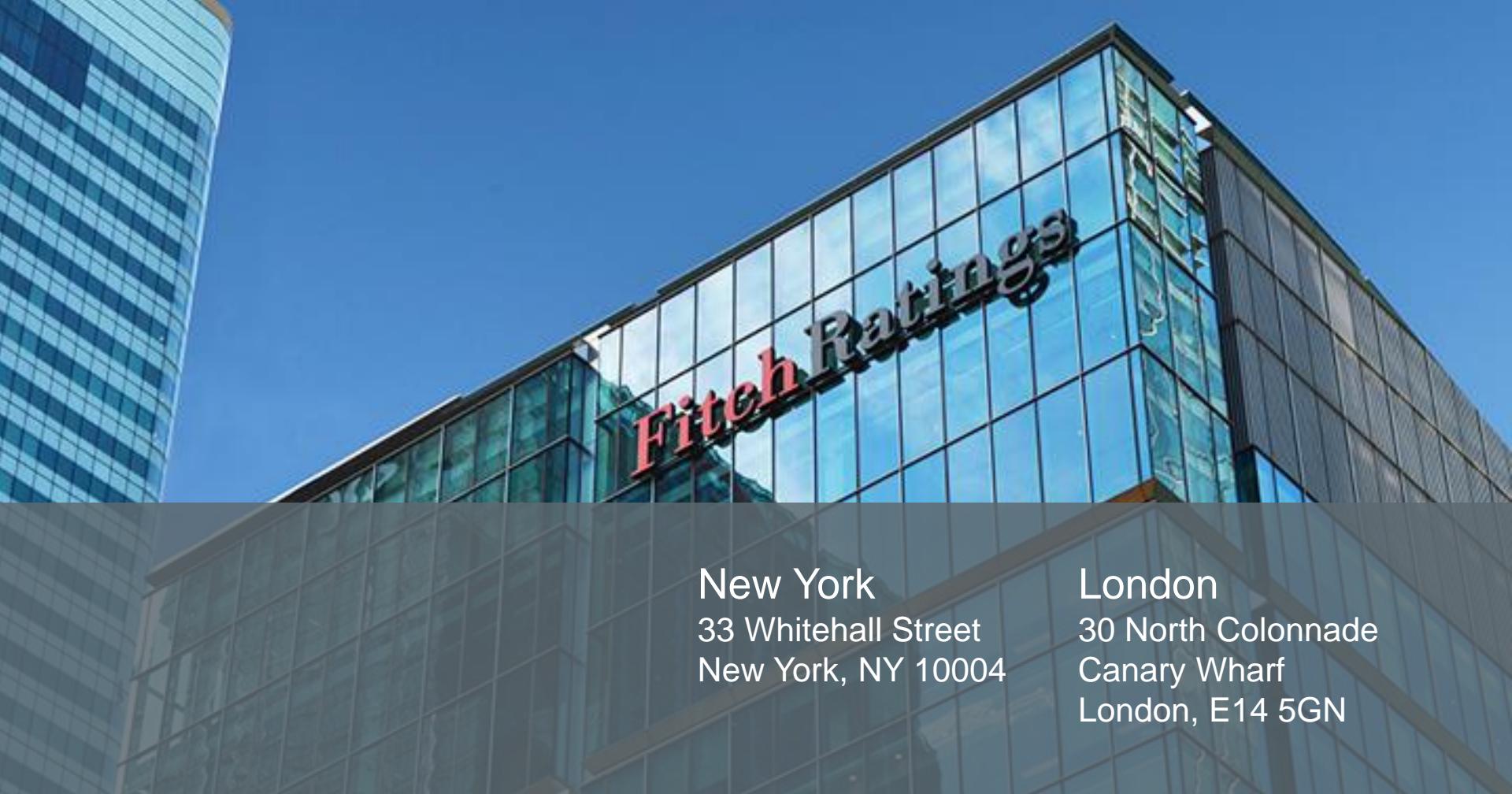
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