

LIHC MONTHLY REPORT

A MONTHLY PUBLICATION OFFERING NEWS, OPINION, FEATURES AND COMMENTARY ON THE LOW-INCOME HOUSING TAX CREDIT INDUSTRY

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State Budget Squeeze - Funding, Credit Ratings in Balance

By Alex Ruiz, Staff Writer, Novogradac & Company LLP

Despite recent predictions of an impending recovery for the nation's economy, the outlook for state budgets remains dim. And while the effects will, in many cases, be indirect, there are a number of ways the shortages will have an impact on the affordable housing industry.

As state legislators are faced with making decisions that could threaten some sources of affordable housing funding, low-income housing tax credits (LIHCs) may offer some relief for developers when those sources dry up. And even though the amount of available tax credits will not be affected by budget cuts, some of the state agencies that administer the LIHC program may be affected.

Moreover, certain states' budget-balancing measures have the potential to affect their general obligation credit ratings. These ratings will not directly impact the ratings of most tax-exempt bonds used for affordable housing, but a state's credit rating does have the potential to affect a state's or local housing finance agency's (HFA) credit ratings – the criteria used to determine the rating of housing bonds often includes the HFA's relationship with state and local governments.

The Big Picture

Before taking into consideration budget-balancing measures, the combined deficit facing states in fiscal year 2003 could reach \$30 billion, according to a report late last year from DRI/WEFA, an economic analysis and consulting firm. Many states are experiencing severe deficits for 2003; New York reports a budget gap of \$5.7 billion and California has weighed in for 2003 with an initial shortfall of \$12 billion. According to the Building Industry Association (BIA), 46 states have reported revenues below projections and as many as 39 states are planning budget cuts.

Federal Stimulus May Stunt State Revenues

Additional worry has been raised in a number of states that the economic stimulus signed last month by President Bush will have an adverse effect on state revenues. Specifically, the National Conference of State Legislatures has said that the bonus depreciation provisions in the Job Creation and Worker Assistance Act will force states to make even more spending cuts. The estimated cost to states is \$5.4 billion in revenues in 2002, \$5.1 billion in 2003 and \$4.2 billion in 2004, according to the Congressional Research Service.

Several governors have expressed concern, including West Virginia Gov. Bob Wise who approximates the loss in revenues for his state at close to \$86 million. The Illinois Department of Revenue predicts \$400 million in additional lost revenue, and Gov. Mike

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LIHC WATCH

According to an auditor with the California Franchise Tax Board, California does not conform with the new federal rules and regulations passed by Notice 2001-70, which provides guidance to taxpayers on electing out of the mid-quarter convention rules related to certain property placed in service in the taxable year which includes September 11, 2001. This notice announced that the Treasury Department and the Internal Revenue Service intends to issue regulations permitting taxpayers to elect to apply the

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Johanns has asked legislators for relief for the estimated \$35 million in revenue losses he says his state will sustain.

State-Level Funding Threatened

But even before the stimulus package was approved, states across the nation were struggling with deficits. In Minnesota, where legislators are battling a \$1.95 billion deficit for 2002-03, Gov. Jesse Ventura proposed a 7.2 percent reduction in funding to the Minnesota Housing Finance Agency (MHFA), which administers several housing assistance programs, including the LIHC program. A compromise in the state legislature resulted in a mere .27 percent cut in MHFA's base budget in the coming biennium.

On a larger scale, the state legislative analyst's office (LAO) has projected that California will end 2001-02 with a deficit of \$4.5 billion and faces a shortfall of \$12.4 billion in 2002-03. According to the LAO, the budget deficit is largely due to slowed revenue growth, which fell to 8 percent in 2000-01 from 22 percent the year before.

Gov. Gray Davis's proposed budget for California's Department of Housing and Community Development (HCD) 2002-03 reduces funding for several programs, such as the Farmworker Housing Grant Program, and eliminates funds for others. The Multifamily Housing Program (MHP), for example, is HCD's basic funding mechanism for low-interest construction loans for multifamily housing units. In 2001-02, MHP was appropriated \$23.1 million from the state's general fund, but under the proposed budget it would receive no funding in 2003.

There is potential, however, that other funding sources will help offset shortages. With the passage of Senate Bill 73, California recently increased its cap of state LIHCs from \$50 million to \$75 million. And at the local level, the Los Angeles City Council last month approved a plan to create a \$100 million affordable housing trust fund.

Other states, including New York, are also relying on tax credits to bridge the gap in housing funds. Obviously affected by the events of the last year, the New York state budget is faced with a deficit of \$5.7 billion. Gov. George Pataki announced in late January that he had included in his proposed 2003 budget a commitment of \$2 million annually for the state tax credit fund, which went unfunded in 2001-02. The state also expects the \$5 million increase in federal LIHCs that took effect in 2002 to help fill some gaps in affordable housing funding.

Credit Ratings At Risk

Standard & Poor's (S&P) has been keeping a close watch on the reports of budget deficits as well as the various actions being taken to deal with them. Last month S&P hosted a teleconference specifically addressing state budget deficits and their impact on states' general obligation credit ratings.

Presented by Robin Prunty and Alex Fraser of S&P's State and Local Governments team, the teleconference visited some of the issues facing the states on its rating system. Since October, S&P has changed several state ratings and placed four

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Publisher

Michael J. Novogradac

Editor

Jane Bowar Zastrow

Staff Writer

Alex Ruiz

Technical Editor

Robert S. Thesman

Contributor

James R. Kroger

Production

Alexandra Louie

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LIHC INFORMATION

Address all correspondence
and editorial submissions to:
Jane Bowar Zastrow
LIHC Monthly Report
Novogradac & Company LLP
246 First Street, 5th Floor
San Francisco, CA 94105
Telephone: 415.356.8034
E-mail: cpas@novoco.com

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MW Development

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states on CreditWatch, a heightened level of surveillance by credit analysts. The call highlighted issues from S&P's recent publication, "State of the States: Fiscal 2003 Presents Many Challenges." Among the report's primary findings were:

- Credit weakness and economic performance has not been as regional as in years past;
- The shape and pace of the recovery will be a key credit determinant;
- Spending reductions abound; and
- Budget actions are beginning to bring pressure to local credit.

"There have not been a lot of rating changes to date, but the 2003 budget is presenting a lot of fiscal challenges to states," Prunty says. States must face these challenges, she says, in order to preserve their credit ratings for the future.

And balancing a budget wouldn't necessarily guarantee a sound rating for a state. One-shot measures, as opposed to long-term solutions, are generally less favorable than other methods of balancing budgets, Fraser says, but there is no strict rule for S&P's tolerance for such measures. According to Fraser, each state is evaluated on a case-by-case basis, and special consideration is taken for states with extenuating circumstances, such as New York, or states with strong fiscal records.

The outlook for states is varied; their long-term fiscal standings and credit ratings will be greatly affected by the pace of their recovery and the budget decisions they make now, Prunty says.

Fraser warns that the outlook will continue to change in the coming months while legislators continue to crunch numbers and battle over cuts, revised numbers continue to come in. "There is more to come," he says. "Stay tuned." ❖