

**X00A00
Public Debt**

Operating Budget Data

(\$ in Thousands)

	<u>FY 04</u>	<u>FY 05</u>	<u>FY 06</u>	<u>FY 05-06</u>	<u>% Change</u>
	<u>Actual</u>	<u>Working</u>	<u>Allowance</u>	<u>Change</u>	<u>Prior Year</u>
Special Fund	\$536,819	\$1,184,840	\$617,575	-\$567,265	-47.9%
Total Funds	\$536,819	\$1,184,840	\$617,575	-\$567,265	-47.9%

- The fiscal 2005 working appropriation includes \$631.1 million of bond proceeds realized during the October 2004 bond refunding. If this amendment is excluded, the fiscal 2005 working appropriation for net debt service is \$553.8 million.
- In fiscal 2006, net debt service increases \$63.8 million over fiscal 2005, after adjusting for the budget amendment of \$631.1 million.

Note: Numbers may not sum to total due to rounding.

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Analysis in Brief

Major Trends

State Maintains AAA Bond Rating and Long-term Debt Is Affordable: The State continues to carefully manage its debt and maintain its AAA bond rating. All three rating agencies reaffirmed the State's AAA rating prior to the October 2004 bond refunding. Out-year projections remain within affordability limits. Increases in the property tax assessable base provide for sufficient revenues to allow debt service tax rates to be reduced from 2005 levels.

Issues

Capital Debt Affordability Committee Considers Proposed Debt Issuances Affordable: The Capital Debt Affordability Committee (CDAC) has proposed authorizing \$670 million in general obligation bond debt in the fiscal 2006 capital budget. The proposed debt level is affordable. It is estimated that there is sufficient capacity to issue an additional \$280 million annually in debt. **The Treasurer should be prepared to brief the committees on the affordability of State debt and the amount of additional capacity available.**

Increased Property Tax Assessments Generate Proposals to Reduce State Property Tax Rates: In November 2004, the State Department of Assessments and Taxation increased its estimate of the fiscal 2006 assessable base for property taxes. If State property tax rates remain at \$0.132 per \$100 of assessable base, there are sufficient revenues through fiscal 2010 to support debt service without general fund revenue subsidies. There are proposals to reduce property tax rates. **The Treasurer should brief the budget committees on the status of the Annuity Bond Fund. This should include the effects of reducing property tax rates.**

The Cost of Additional Debt for Public School Construction at Levels Proposed Is Substantial and How to Support these Costs Is Yet to Be Resolved: Legislation enacted in 2004 created a State goal to fund public school construction \$2 billion from fiscal 2006 to 2013. The Administration's plan funds \$857.6 million. Funding the remaining \$1.14 billion gap requires \$1.75 billion over 27 years. **The Treasurer should brief the committees on the affordability of authorizing additional debt for public school construction and also the costs associated with higher debt issuances.**

Major Credit Rating Agencies Consider Grant Anticipation Revenue Vehicles (GARVEEs) to Be State Debt: The Maryland Department of Transportation plans to issue significant levels of GARVEEs. Two of three credit rating agencies consider GARVEEs to be State debt. GARVEEs are not currently considered State debt when evaluating limits. **Insofar as rating agencies believe that GARVEEs should be included in State debt calculations, it is recommended that CDAC include GARVEEs in the State debt limit calculation.**

State Should Reevaluate Debt Affordability Criteria to Determine How They Can Best Manage Under the State’s Fiscal Condition: Currently, the State has a criterion for limiting debt outstanding and a criterion for limiting debt service. The debt outstanding criterion has become the controlling criterion. Given the State budget’s long-term structural deficit, there are concerns that the criteria do not appropriately weight debt service. **It is recommended that committee narrative requiring the reevaluation of affordability criteria be adopted.**

Recommended Actions

1. Adopt committee narrative requiring the Capital Debt Affordability Committee to reevaluate its affordability criteria.

X00A00 – Public Debt

X00A00 Public Debt

Operating Budget Analysis

Program Description

There are two programs in the Public Debt:

- debt service, which funds principal and interest payments on general obligation (GO) bonds. GO bond debt service payments are supported by the Annuity Bond Fund (ABF). Funds are generated from property tax revenues, general funds, and repayments from certain State agencies, subdivisions, and private organizations. All property taxes generated by the State are deposited in the ABF to support debt service. The fund can also receive reimbursable funds first appropriated as general funds in the Maryland State Department of Education (MSDE) budget to pay debt service on public school construction loans. The ABF has not received MSDE funds since fiscal 2003, when there was a general fund appropriation; and
- related expenses on State bonds, which includes arbitrage penalty payments and special funds resulting from refunded bonds. The funds generated by refunding bonds are used to purchase government securities that provide the debt service payment to the bondholders. For purposes of setting debt limits, refunded bonds are not included in State debt calculations.

Fiscal 2005 Bond Refunding

In October 2004, the State issued \$574.7 million in GO bonds to refund previously issued bonds with a par value totaling \$589.2 million. The bond sale generated \$631.6 million (net of delivery date expenses, which include the underwriter's discount and cost of issuance fees). The funds generated include a \$56.7 million premium. A budget amendment appropriating the funds was approved. The bond proceeds purchased federal State and Local Government Series (SLGS) securities which are deposited into an escrow account to support the debt service of the refunded bonds. The SLGS ensure that the refunded bonds comply with federal tax-exempt yield restrictions.

Exhibit 1 shows that the refunding reduced the State's GO bond debt service expenditures by \$22.5 million between fiscal 2005 and 2016. Fiscal 2005 savings attributable to the refunding totaled \$8.5 million. The State's total debt outstanding was also reduced by \$14.6 million.

Exhibit 1
October 2004 GO Bond Refunding
Reduced Debt Outstanding and Debt Service Expenditures
(\$ in Thousands)

<u>Series</u>	<u>Refunded Principal</u>	<u>New Principal</u>	<u>Reduced Debt Outstanding</u>	<u>Debt Service Savings</u>	<u>NPV of Savings</u>
1994 Third Series	\$13,395	\$12,960	\$435	\$359	\$462
1995 Second Series	68,570	65,270	3,300	2,998	3,309
1996 First Series	77,830	74,865	2,965	3,407	2,946
1996 Second Series	69,360	68,280	1,080	4,563	3,583
1996 Third Series	78,755	75,815	2,940	2,523	2,864
1997 First Series	110,625	107,520	3,105	4,207	4,207
1997 Second Series	94,365	91,780	2,585	2,165	3,188
2000 First Series	76,335	78,165	-1,830	2,271	3,081
Total	\$589,235	\$574,655	\$14,580	\$22,494	\$23,639

NPV = Net Present Value

Source: Public Resources Advisory Group, October 2004

Governor's Proposed Budget

The fiscal 2006 allowance totals \$617.6 million. This is \$63.8 million (11.5%) greater than the net fiscal 2005 debt service appropriation. (As previously discussed, fiscal 2005 includes appropriations for a bond refunding which skews the base level of funding for ongoing debt service.) The increase is attributable to higher GO bond authorizations and issuances in recent years. New issuances increased from about \$400 million annually in fiscal 2001 and 2002 to \$725 million in fiscal 2003, \$500 million in 2004, and an estimated \$775 million (including taxable issuances) in fiscal 2005.

Exhibit 2 shows the activity of the ABF which supports the State's GO bond debt service. As in previous years, most of the revenues supporting debt service are generated through property tax receipts. This allowance represents a change in debt service policy by the Administration. In fiscal 2004 and 2005, the State property tax rate was \$0.132 per \$100 of assessable base, generating \$468 million and \$513 million in property tax receipts, respectively. Recent assessments were considerably higher than previously estimated, generating substantially more revenues in fiscal 2006. The Governor's fiscal 2006 budget proposes that the property tax rate be reduced to \$0.122 per \$100 of assessable base. The implications of this policy are discussed in Issue 2.

Exhibit 2
Annuity Bond Fund Activity
Fiscal 2004 to 2006
(\$ in Thousands)

	<u>FY 2004</u> <u>Actual</u>	<u>FY 2005</u> <u>Approp.</u>	<u>FY 2006</u> <u>Allowance</u>
Special Fund Income			
Beginning Balance	\$20,295	\$48,998	\$101,407
Property Tax Receipts	468,355	512,824	523,986
Interest and Penalties on Property Taxes	1,780	1,200	1,200
Local Loan Repayments	2,839	2,432	2,401
Miscellaneous Receipts	4,291	200	200
Accrued Interest on Bonds Sold	278	500	0
Bond Premium	87,979	89,036	34,000
Transfer to Reserve	-48,998	-101,407	-45,619
Subtotal Special Funds Net Debt Service	\$536,819	\$553,783	\$617,575
Refunded Bond Proceeds	0	631,056	0
Total Special Funds for Debt Service	\$536,819	\$1,184,840	\$617,575
Public Debt Total Expenditures			
Redemption and Interest on State GO Bonds	\$536,819	\$553,783	\$617,575
SLGS Purchased for Refunded Bonds	0	631,056	0
Total Expenditures	\$536,819	\$1,184,840	\$617,575

Note: Numbers may not sum to total due to rounding

Source: Governor's FY 2006 Budget, Volume III, Page 733

The GO bonds' interest rates are projected to remain below 5% through calendar 2005 so the State is still expecting some bond premiums in the March and summer 2005 bond sales. These bond sales' premiums are expected to generate \$34 million.

Revenues generated by the ABF are expected to be \$56 million less than fiscal 2006 debt service requirements. Consequently, the fiscal 2006 end-of-year balance is projected to be \$46 million, down from \$101 million at the end of fiscal 2005.

Issues

1. Capital Debt Affordability Committee Considers Proposed Debt Issuances Affordable

Chapter 43, Acts of 1978, created CDAC. The committee is required to recommend an estimate of State debt to the General Assembly and Governor. The committee is chaired by the State Treasurer, and other committee members are the Comptroller, Secretaries of Transportation and Budget and Management, and an individual appointed by the Governor. The committee meets each summer and fall to evaluate State debt levels and recommend prudent debt limits to the Governor and General Assembly. The Governor and General Assembly are not bound by the committee's recommendations.

When reviewing State debt, CDAC considers GO bonds, consolidated transportation bonds, stadium authority bonds, bay restoration bonds, and capital leases supported by State revenues. Bonds supported by non-State revenues, such as the University System of Maryland's Auxiliary Revenue bonds or the Maryland Transportation Authority's revenue bonds, are not considered to be State source debt and are not included in CDAC's debt affordability calculation.

Exhibit 3 shows that CDAC proposed \$670 million in GO debt for the 2005 session. The long range plan adopted by the committee provides for \$15 million in annual increases through the 2008 session. The committee proposes to reduce the 2009 authorization as recommended in the committee's 2003 report. In its 2003 report, the committee recommended that authorizations be increased \$100 million in each session from 2004 to 2008, to realize an additional \$500 million in authorizations. At the time, it was agreed that the authorizations be reduced again in 2009 to levels consistent with previously proposed levels.

Exhibit 3
Capital Debt Affordability Committee
Recommended Levels of General Obligation Bond Authorizations
(**\$ in Millions**)

<u>Session</u>	<u>Proposed GO Bond Authorizations</u>	<u>Change from Previous Authorization</u>
2005	\$670	\$15
2006	685	15
2007	700	15
2008	715	15
2009	630	-85
2010	645	15

Source: *Report of the Capital Debt Affordability Committee on Recommended Debt Authorizations for Fiscal 2006*, September 2004

Proposed Levels of State Debt Are Affordable

CDAC currently uses two criteria to evaluate debt. Total State debt outstanding should be limited to 3.2% of State personal income, and total State debt service should be limited to 8% of State revenues supporting debt service. **Exhibit 4** shows that the State currently meets both criteria, as debt outstanding peaks at 2.78% of personal income in fiscal 2006 and debt service peaks at 6.18% of revenues in fiscal 2010.

Exhibit 4
Capital Debt Affordability Committee's Criteria
Proposed Debt Levels Are Affordable

<u>Fiscal Year</u>	<u>Debt Outstanding/ Personal Income</u>	<u>Debt Service/ Revenues</u>
2005	2.77	5.91
2006	2.78	6.09
2007	2.72	5.85
2008	2.69	5.92
2009	2.71	6.08
2010	2.72	6.18

Source: Department of Legislative Services, February 2005

There Is Sufficient Capacity to Issue \$280 Million in Additional GO Debt Annually

Based on the CDAC criteria, the State also has significant unused debt capacity. The Department of Legislative Services (DLS) estimates that the State could issue an additional \$280 million annually in GO debt and remain within the State’s affordability criteria. Assuming that debt is issued in the spring, **Exhibit 5** shows that issuing this debt would increase debt service payments, which would begin increasing in fiscal 2007 by \$14 million. By fiscal 2010, debt service would be \$91 million more. Additional debt service would peak in fiscal 2013 and would be \$152 million more than if the State maintained its current growth limits.

Exhibit 5
Capital Debt Affordability Committee
Effect of Issuing Maximum GO Bonds on Debt Service
Fiscal 2006 to 2010

<u>Fiscal Year</u>	<u>Current Debt Service</u>	<u>Expanded Debt Service</u>	<u>Increase</u>
2006	\$618	\$618	\$0
2007	643	657	14
2008	682	711	29
2009	731	791	60
2010	766	857	91

Source: Department of Legislative Services, February 2005

The slow growth in debt service is attributable to how the State amortizes GO bonds. In the first two years, the bonds only pay interest. Debt is retired from year 3 to year 15. In the example on the next page, fiscal 2009 debt service increases substantially because that is when the State begins retiring the first bonds issued in the spring of 2006.

Exhibit 6 shows that increasing debt issuance by \$280 million annually initially adds \$280 million each year to total debt outstanding. By fiscal 2009, the State would begin retiring some of the debt, slowing the growth in debt outstanding. Total debt outstanding peaks at \$1.35 billion in fiscal 2010 and continues to decline thereafter.

Exhibit 6
Capital Debt Affordability Committee
Effect of Issuing Maximum GO Bonds on Debt Outstanding
Fiscal 2006 to 2010

<u>Fiscal Year</u>	<u>Current Debt Outstanding</u>	<u>Expanded Debt Outstanding</u>	<u>Increase</u>
2006	\$4,778	\$5,058	\$280
2007	5,030	5,590	560
2008	5,286	6,126	840
2009	5,533	6,637	1,104
2010	5,760	7,112	1,352

Source: Department of Legislative Services, February 2005

This capacity analysis examines increasing GO bonds while maintaining all other debt issuances at currently projected levels. If the State were to maximize GO bond debt, it would preclude the State from issuing any other State debt and maintaining State debt within the limits set by CDAC. Specifically, this would limit transportation debt, stadium authority debt, bay restoration bond debt, and capital leases to currently forecasted levels.

The Treasurer should be prepared to brief the committees on the affordability of State debt and the amount of additional capacity available.

2. Increased Property Tax Assessments Generates Proposals to Reduce State Property Tax Rates

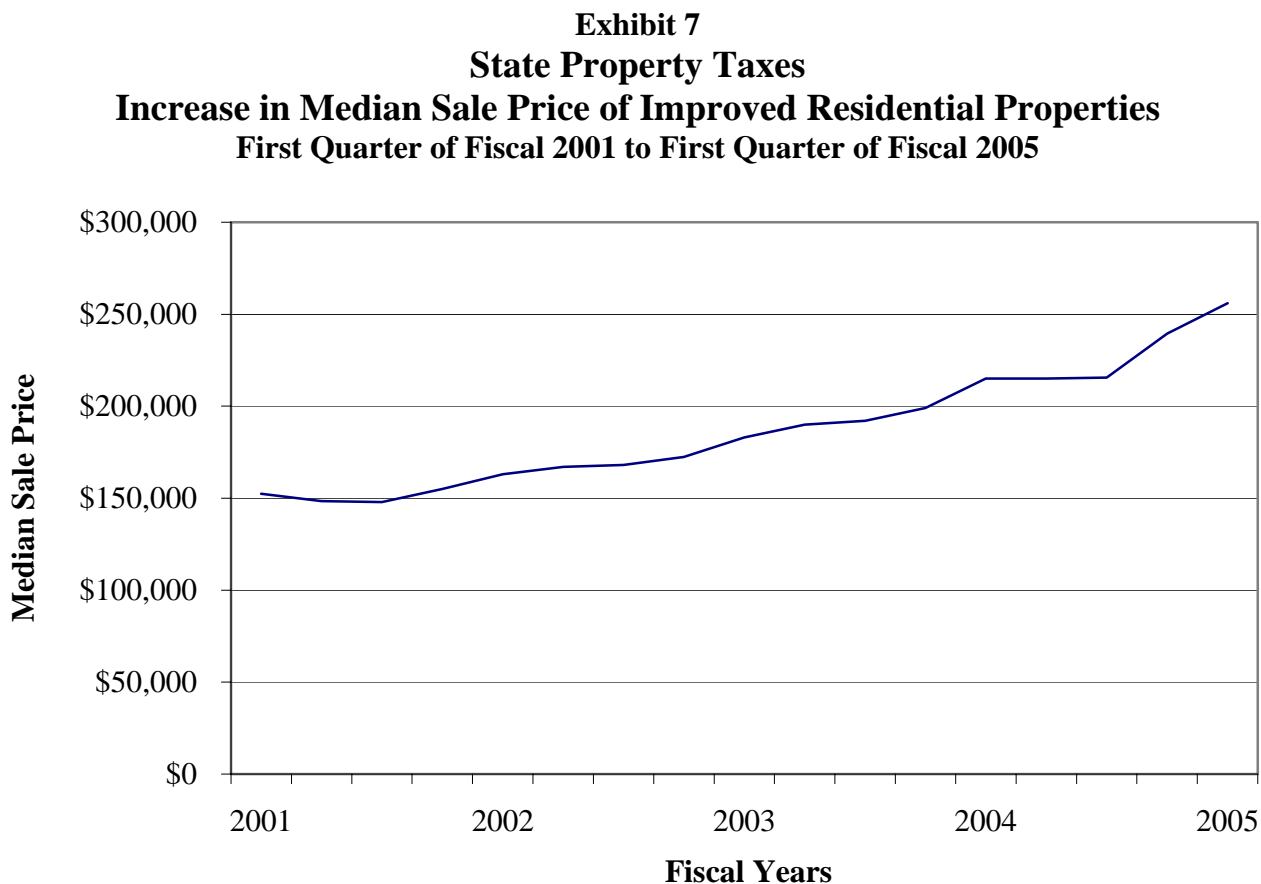
GO bond debt service costs are supported by the ABF. Until fiscal 2003, property tax rates remained constant at \$0.084 per \$100 of assessable base. At this level, State property taxes supported approximately 55% to 60% of debt service costs. Any bond sale premiums generated increased the fund balance. In subsequent years these accumulated fund balances were reduced by appropriating the funds for debt service payments, which reduced the general fund requirement. Since property taxes, bond sale premiums, and other revenues were insufficient to pay the entire debt service amount, general funds were appropriated to support the remaining debt service costs.

The State did not appropriate general funds for ABF in the fiscal 2004 budget. Consequently, the Board of Public Works (BPW), which sets the State property tax rate, increased the State property tax rate to \$0.132 per \$100 of assessable base. With these actions, the State moved from maintaining a constant property tax rate and funding any remaining debt service with general funds, to funding the entire debt service payment with property taxes (as well as some smaller revenue sources).

In November 2004, the State Department of Assessments and Taxation (SDAT) revised its projected property tax assessable base upward. Consequently, property tax revenues are expected to rise. This creates both an opportunity and a problem. The opportunity is to eliminate the projected out-year deficit in the ABF. The problem is that even without raising rates, State taxpayers living in the same house that they have lived in for years will be paying as much as 10% more in property taxes in fiscal 2006. Proposals to reduce property tax rates to allow for some property tax relief have been introduced.

Rise in Property Values Increase the State’s Assessable Base

Property values have risen substantially across Maryland in recent years. According to data from SDAT, the median sale price of houses sold in Maryland has increased in all jurisdictions since fiscal 2002. **Exhibit 7** shows the steady increase in housing values since fiscal 2001: by fiscal 2005, the median price of a home sold in Maryland was \$256,000, which is 68% greater than the price in the first quarter of fiscal 2001.



Source: Department of Assessments and Taxation

X00A00 – Public Debt

The effect of the increased sale price of housing can be seen in the increase in the real property assessable base. For example, the assessable value of real property increased from \$314.9 billion in fiscal 2002 to \$445.6 billion in fiscal 2006. Because of this increase, SDAT increased its estimate of fiscal 2006 real property values by 4.4%, from \$428.8 billion to \$445.6 billion. Since this increase is expected to be sustained, it also resulted in an upward revision of the estimate of the fiscal 2007 to 2010 assessable base.

Property Value Increases Eliminate Out-year Revenue Shortfall

This increase in property values has essentially eliminated the structural deficit in the ABF over the fiscal 2006 to 2010 forecast period. Last January, it was estimated that that ABF revenues were \$115 million less than expenditures in fiscal 2007, 2008, and 2009. If the State property tax rate is maintained at the current level, the current estimate projects that there are sufficient funds in the ABF to support debt service through fiscal 2010. **Exhibit 8** shows that there are sufficient funds to provide a \$16 million fund balance at the end of fiscal 2010. Since property tax receipts are still less than debt service, the State reduces the ABF balance to support debt service. The effect of maintaining the State property tax at its current rate would be to entirely fund debt service with property taxes and to slowly draw down the projected \$101 million fund balance down to \$16 million.

Exhibit 8
Annuity Bond Fund Forecast
State Property Tax of \$0.132 per \$100 of Assessable Base
Fiscal 2006 to 2010
(\$ in Millions)

	<u>FY 05</u>	<u>FY 06</u>	<u>FY 07</u>	<u>FY 08</u>	<u>FY 09</u>	<u>FY 10</u>
Special Fund Revenues						
Property Tax Receipts	\$513	\$567	\$607	\$660	\$710	\$766
Bond Sale Premiums	89	34	0	0	0	0
Other Revenues	4	4	3	2	1	1
ABF Fund Balance Transferred from Prior Year	49	101	88	54	34	15
Subtotal Special Fund Revenues Available	\$655	\$706	\$697	\$716	\$746	\$781
General Fund Revenues	0	0	0	0	0	0
Total Revenues	\$655	\$706	\$697	\$716	\$746	\$781
Projected Debt Service Expenditures	\$554	\$618	\$643	\$682	\$731	\$766
ABF End-of-year Fund Balance	\$101	\$88	\$54	\$34	\$15	\$16

Source: Department of Legislative Services, February 2005

Property Tax Relief Is Proposed

Concerns have been raised that property taxes are becoming too much of a burden on property owners in Maryland. The Governor’s proposed budget provides some property tax relief. The fiscal 2006 budget assumes that State property tax rates will be reduced by one cent, to \$0.122 per \$100 of assessable base, by the BPW. If SDAT’s median sale price is used, this proposed reduction would reduce a household’s State property tax bill by \$26 (from \$338 to \$312). **Appendix 3** shows the savings for homeowners for housing values assessed from \$100,000 to \$3 million.

Exhibit 9 compares the effect of reducing the State property tax rate one cent on State property tax revenue receipts. The tax relief reduces receipts by \$43 million in fiscal 2006. By fiscal 2010, the reduction is \$58 million. Over the entire forecast period, revenues are estimated to be \$250 million less than they otherwise would have been.

The exhibit also shows how the State would need to backfill those revenues. Insofar as the current forecast has a \$16 million fund balance at the end of fiscal 2010, there is \$15 million in fund balances that could support debt service. The remaining shortfall, \$235 million, would need to be supported by general funds, or some other revenue source. By reducing the State property tax rate, the fund balance is drawn down more quickly and is eliminated in fiscal 2007. Beginning in fiscal 2007, the State would need to provide additional revenue to support debt service payments. The bottom line is that any reductions in property tax rates must be almost entirely made up by transferring other revenues to the ABF. If this includes general funds, this would worsen the general fund structural deficit to the extent offsetting revenues or cost reductions do not occur.

Exhibit 9
Annuity Bond Fund Forecast
Effect of Reducing State Property Tax Rate One Cent
Fiscal 2006 to 2010
(\$ in Millions)

Effect of Rate Reduction on Revenues	<u>FY 06</u>	<u>FY 07</u>	<u>FY 08</u>	<u>FY 09</u>	<u>FY 10</u>	<u>Total</u>
Property Tax Receipts at \$0.132 Rate	\$567	\$607	\$660	\$711	\$766	\$3,310
Property Tax Receipts at \$0.122 Rate	524	561	611	657	708	3,060
Less Property Tax Revenues Received	-\$43	-\$46	-\$50	-\$54	-\$58	-\$250
Funds Backfilling Lost Revenues						
Draw Down (Replenish) Fund Balance	\$43	\$11	-\$20	-\$20	\$1	\$15
Annual GF to Support Tax Rate Reduction	0	35	70	74	57	235
Total Funds Backfilling Lost Revenues	\$43	\$46	\$50	\$54	\$58	\$250

Source: Department of Legislative Services, February 2005

X00A00 – Public Debt

Another tax relief concept is to reduce State property tax rates to the fiscal 2003 level, which was \$0.084 per \$100 of assessable base. If SDAT’s median sale price is used, this proposed reduction would reduce a household’s State property tax bill by \$123 (from \$338 to \$215). **Appendix 4** shows the savings for homeowners for housing values assessed from \$100,000 to \$3 million.

Exhibit 10 shows that this would reduce projected State property tax receipts by \$1.2 billion. In fiscal 2006, the State is estimated to need \$167 million in other revenues to support debt service. As with a one cent reduction, the State has a \$16 million fund balance at the end of fiscal 2010 that could be used to support debt service payments. The remaining \$1.185 billion would need to be supported by other revenues. By reducing the State property tax rate, the fund balance is drawn down more quickly and other funds would be needed to support debt service. If general funds are used, this will exacerbate the State’s general fund structural deficit to the extent offsetting revenues or cost reductions do not occur.

Exhibit 10
Annuity Bond Fund Forecast
Effect of Reducing State Property Tax Rate to Fiscal 2003 Level
Fiscal 2006 to 2010
(\$ in Millions)

Effect of Rate Reduction on Revenues	FY 06	FY 07	FY 08	FY 09	FY 10	Total
Property Tax Receipts at \$0.132 Rate	\$567	\$607	\$660	\$711	\$766	\$3,310
Property Tax Receipts at \$0.084 Rate	362	387	421	453	488	2,110
Less Property Tax Revenues Received	-\$205	-\$220	-\$240	-\$258	-\$278	-\$1,200
Funds Backfilling Lost Revenues						
Draw Down (Replenish) Fund Balance	\$38	\$16	-\$20	-\$19	\$1	\$15
Annual GF to Support Tax Rate Reduction	167	204	260	277	277	1,185
Total Funds Backfilling Lost Revenues	\$205	\$220	\$240	\$258	\$278	\$1,200

Source: Department of Legislative Services, February 2005

The Treasurer should brief the budget committees on the status of the Annuity Bond Fund. This should include the effects of reducing property tax rates.

3. The Cost of Additional Debt for Public School Construction at Levels Proposed Is Substantial and How to Support these Costs Is Yet to Be Resolved

Chapters 306 and 307, Acts of 2004 also referred to as the Public School Facilities Act of 2004, established a State goal to fully fund school construction projects by fiscal 2013 to meet all minimum required standards as of July 2003. The Act was a response to the November 2003 survey results of the Task Force to Study Public School Facilities. The task force concluded that many Maryland public schools were deficient in some capacity and that the cost to bring schools up to standard would

X00A00 – Public Debt

be \$3.85 billion. Through the Public School Facilities Act, the State would provide \$2 billion of the \$3.85 billion over the next eight fiscal years, with the remaining balance funded by local governments. **Exhibit 11** shows that the State has currently committed to \$857.6 million in the Department of Budget and Management’s (DBM) *Capital Improvement Program* (CIP), leaving a \$1.14 billion shortfall.

Exhibit 11
Public School Construction Program
Planned Funding Compared to State Goal
Fiscal 2006 to 2013

<u>Fiscal Year</u>	<u>School Construction Program</u>	<u>State Goal</u>	<u>Shortfall</u>
2006	\$157.6	\$250.0	\$92.4
2007	100.0	250.0	150.0
2008	100.0	250.0	150.0
2009	100.0	250.0	150.0
2010	100.0	250.0	150.0
2011	100.0	250.0	150.0
2012	100.0	250.0	150.0
2013	100.0	250.0	150.0
Total	\$857.6	\$2,000.0	\$1,142.4

Notes: CIP totals include special funds budgeted in the operating budget.
Fiscal 2011 to 2013 is an estimate based on fiscal 2007 to 2010 trends.

Source: FY 2006 Capital Budget Book and Chapters 306 and 307, Acts of 2004

Meeting the Task Force’s Goal to Increase School Construction Is Costly

To provide \$2 billion in State school construction funds over eight years requires an additional \$92.6 million in fiscal 2006 and \$150 million annually from fiscal 2007 to 2013. **Exhibit 12** shows that this is projected to cost over \$1.7 billion if additional GO bonds are issued to support public school construction. Based on data from recent public school construction authorizations, authorized funds would not be spent immediately. Instead, the program would need to be phased in over a number of years. Based on recent data from the Interagency Committee on School Construction (IAC), DLS estimates that about half the authorized funds would be issued in the first year after authorization. If authorizations are increased in the 2005 session, the first debt service payment is projected to be \$2.3 million in fiscal 2007. As the program progresses, debt service costs increase to over \$100 million annually in 10 years, peaking at \$125 million annually in 2020.

Exhibit 12
Public School Construction Program
Projected Costs Associated with Authorizing an
Additional \$1.14 Billion in GO Debt
Fiscal 2006 to 2032
(\$ in Millions)

<u>Fiscal Year</u>	<u>Debt Authorized</u>	<u>Debt Issued</u>	<u>Debt Service</u>	<u>Debt Outstanding</u>
2006	\$92.4	\$46.2	\$0.0	\$46.2
2007	150.0	102.7	2.3	148.9
2008	150.0	129.2	7.7	278.2
2009	150.0	139.6	17.4	415.2
2010	150.0	147.1	30.8	553.8
2011	150.0	150.0	46.0	687.9
2012	150.0	150.0	61.8	813.5
2013	150.0	150.0	78.1	929.7
2014	0.0	75.0	94.6	960.9
2015	0.0	30.0	106.9	936.5
2016	0.0	15.0	116.8	885.9
2017	0.0	7.5	121.7	820.2
2018	0.0	0.0	123.8	741.3
2019	0.0	0.0	124.6	657.3
2020	0.0	0.0	125.0	568.4
2021	0.0	0.0	125.0	474.6
2022	0.0	0.0	120.1	380.6
2023	0.0	0.0	109.0	292.6
2024	0.0	0.0	94.8	213.9
2025	0.0	0.0	79.5	146.1
2026	0.0	0.0	63.3	90.8
2027	0.0	0.0	46.9	48.9
2028	0.0	0.0	30.4	21.2
2029	0.0	0.0	14.0	8.4
2030	0.0	0.0	5.8	3.1
2031	0.0	0.0	2.5	0.8
2032	0.0	0.0	0.8	0.0
Total	\$1,142.4	\$1,142.4	\$1,749.5	

Source: Department of Legislative Services, February 2005

Additional Debt Meets Current CDAC Affordability Criteria

Based on current projections and affordability standards, issuing additional GO debt to support the public school construction program is affordable. As discussed, debt is affordable if debt outstanding does not exceed 3.2% of personal income and debt service does not exceed 8% of revenues supporting debt service. **Exhibit 13** shows that debt outstanding peaks at 2.9% of personal income and debt service payments peak at 6.37% of revenues.

Exhibit 13
Capital Debt Affordability Committee
Expanding Public School Construction by Issuing Additional Debt Is Affordable

<u>Fiscal Year</u>	<u>Debt Outstanding/ Personal Income</u>	<u>Debt Outstanding Ratio with Additional School Debt</u>	<u>Debt Service/ Revenues</u>	<u>Debt Service Ratio with Additional School Debt</u>
2005	2.77	2.77	5.91	5.91
2006	2.78	2.80	6.09	6.09
2007	2.72	2.77	5.85	5.87
2008	2.69	2.79	5.92	5.97
2009	2.71	2.85	6.08	6.19
2010	2.72	2.90	6.18	6.37

Source: Department of Legislative Services, February 2005

CDAC Does Not Recommend Authorizing Additional Debt

The State’s CDAC was required, by Chapters 306 and 307, to review the school construction needs and make a funding recommendation annually. The committee recommended to the General Assembly that the State continue to authorize \$100 million in public school construction and also analyzed the effect of authorizing an additional \$1.2 billion for public school construction. The committee concluded that authorizing this additional debt would not exceed debt capacity as currently defined, yet the committee warned that such a task would limit the State’s ability to issue debt for other programs along with a caution that changes in personal income could breach affordability measures. The committee concluded that:

“[g]iven the magnitude of the proposed additional funding for school construction, however, the committee recommends fully exploring alternative funding mechanisms, new revenue streams, or shifting other capital projects before considering an additional \$1.2 billion in general obligation bond authorizations.”

X00A00 – Public Debt

As required by law, CDAC examined the effect of issuing additional debt for public school construction. The committee expressed concerns about the magnitude of this proposed expansion and, instead of recommending that the GO bond program be expanded, the committee recommended that the State first examine:

- ***Alternative Financing Sources:*** Chapters 306 and 307, Acts of 2004 authorize the use of alternative financing methods, such as leasing arrangements with contractors, and allows all counties to issue bonds for public school construction. The IAC advises that the regulations pertaining to these new laws are being promulgated and should be implemented in fiscal 2006. The IAC is also monitoring these financing methods to determine which can be applied more broadly across the State.
- ***New Revenues:*** This could entail enacting legislation to expand the revenue base or increasing taxes or fees.
- ***Shifting Funds from Other Projects:*** This could include (1) moving funds from other capital projects into public school construction; (2) moving capital projects into the operating budget; or (3) moving funds supporting operating programs into public school construction. In the fiscal 2006 budget, the Administration proposes to move funds from other capital programs into public school construction. The capital budget bill (House Bill 340/Senate Bill 274) proposes \$157.6 million for school construction. This is an increase of \$57.6 million when compared to the forecasted amount in the DBM's fiscal 2005 *Capital Improvement Program*. The allocation for public school construction was increased by shifting funds out of State construction projects. DLS' GO Bond Overview analysis will examine the implications of these fund shifts on the capital program.

DLS' Concerns about Expanding the GO Program

While the debt is affordable based on CDAC criteria, DLS has the following concerns about expanding GO bond authorizations:

- ***Expanding the Capital Program without Identifying Revenues Could Result in a Revenue Shortfall in the ABF:*** If property tax rates remain at \$0.132 per \$100 of assessable base, revenues in the ABF are just sufficient to fund debt service and provide a \$15 million fund balance. Even at a rate of \$0.132, property tax rates are insufficient to fully fund debt service. An unusually high ABF fund balance is providing the additional funds necessary. Increasing debt authorizations could lead to a shortfall in the ABF or worsen a shortfall if property tax rates are reduced.
- ***Issuing Additional Debt Limits Capacity for Non-GO Bond Financed Projects:*** The proposed increase in school construction debt absorbs over one-third of projected debt capacity in fiscal 2010. The GO bond program is part of the State's debt program. Other components include transportation, bay restoration bonds, stadium authority bonds, and capital leases. Issuing GO debt limits how much the other programs can issue.

Conclusion

Implementing the proposed \$1.2 billion program to expand the public school construction capital program is affordable by CDAC standards. While CDAC criteria limit the State's aggregate debt, the criteria do not examine debt service in the context of the State's current fiscal condition. DLS is concerned about the fiscal impact of authorizing an additional \$1.2 billion in GO bonds, which would add \$1.75 billion in debt service costs. Implementing this proposed program without a source of revenues to pay for the additional costs could create a gap between GO bond debt service costs and revenues. **The Treasurer should brief the committees on the affordability of issuing additional debt for public school construction and also the costs associated with higher debt issuances.**

4. Major Credit Rating Agencies Consider Grant Anticipation Revenue Vehicles (GARVEEs) to Be State Debt

The Maryland Department of Transportation (MDOT) and Maryland Transportation Authority (MdTA) are developing plans to construct an InterCounty Connector in Montgomery and Prince George's counties. MdTA's financing proposal includes issuance of Grant Anticipation Revenue Vehicles (GARVEEs). They are bonds that are issued by states and public authorities, backed by future federal-aid highway and transit appropriations. While the source of funds used to repay GARVEEs originates with the federal government, the federal government's agreement to the use of its funds in this manner does not constitute any obligation on the part of the U.S. government to make these funds available. If for any reason federal appropriations are not made as anticipated, the obligation to repay the GARVEEs falls entirely to the State agency or authority that issued them. To date, the State has not issued any GARVEEs.

In 2004, legislation was enacted that amended Section 8-112 of the State Finance and Procurement Article to require CDAC to review GARVEEs. The policy excludes GARVEEs from the State limit.

Two of the agencies that rate Maryland's GO bonds, Moody's and Fitch, advise that they consider GARVEE bonds to be State debt when they examine the State's taxable debt burden. In its April 2001 report on *State Debt Medians*, Moody's notes that:

While the federal revenues that secure GARVEES are not technically part of the state's tax base, recent changes in federal transportation funding have made the differences between a state's own gas tax and the funds it receives from federal gas taxes relatively small. "Equity" provisions included in TEA-21 [the federal Transportation Equity Act, which authorizes federal funds for transportation] are designed to ensure that states' aid receipts do not fall below a minimum floor level that is closely related to the amount that they contribute to federal gas tax revenues. In addition, TEA-21 continues the trend of increasing flexibility regarding the uses of federal funds. As a result, bonds that leverage federal transportation funds have essentially the same impact on a state's fixed costs and fiscal flexibility as bonds that leverage the state's own gas tax.

X00A00 – Public Debt

Moody’s point is that, while federal transportation funds are not direct State source revenues (as the State gas tax is), these federal funds act essentially like direct State source revenues. Insofar as they act like State revenues, bonds supported by these revenues are to be considered State bonds by rating agencies and investors.

Fitch also considers GARVEEs to be state debt when rating states. In a September 2004 bond rating for Michigan, Fitch included GARVEEs in its calculation of Michigan’s total State debt. Michigan had issued \$600 million in Grant Anticipation Notes (a type of GARVEE backed by federal revenues), all of which was included as state debt.

Proposed debt levels are affordable if GARVEEs are included in the debt affordability calculation. **Exhibit 14** shows that fiscal 2010 debt outstanding to personal income peaks at 2.91 and debt service to revenue peaks at 6.53. These are comfortably below the limits of 3.2 for debt outstanding and 8 for debt service. Including GARVEEs would reduce the amount of debt that could be issued annually from \$280 million to \$190 million.

Exhibit 14
Capital Debt Affordability Committee’s Criteria
Proposed GARVEE Debt Levels Are Affordable

<u>Fiscal Year</u>	<u>Debt Outstanding/ Personal Income</u>	<u>Debt Service/ Revenues</u>
2005	2.77	5.91
2006	2.88	6.17
2007	2.82	5.93
2008	2.87	6.16
2009	2.88	6.31
2010	2.91	6.53

Source: Department of Legislative Services, February 2005

The previous calculation assumes that MDOT’s GARVEE issuances are consistent with current law, which limits debt service payments to 13% of the annual average authorization of federal highway aid funds. Senate Bill 75 proposes to increase this debt service limit to 20%. **Exhibit 15** shows that increasing the GARVEE debt service limit to 20% is affordable based on CDAC criteria. Increasing the limit also reduces capacity. Enacting Senate Bill 75 reduces the amount of additional debt that can be issued to \$110 million annually.

Exhibit 15
Capital Debt Affordability Committee’s Criteria
Proposed GARVEE Debt Levels Are Affordable If Limit Is Increased to 20%

<u>Fiscal Year</u>	<u>Debt Outstanding/ Personal Income</u>	<u>Debt Service/ Revenues</u>
2005	2.77	5.91
2006	2.94	6.22
2007	2.87	5.97
2008	2.98	6.31
2009	2.97	6.45
2010	3.02	6.73

Source: Department of Legislative Services, February 2005

One key element of CDAC’s mission is to protect the State’s bond rating. To effectively accomplish its mission, the committee should reflect State debt consistent with rating agencies’ policies. Under current policies, CDAC does not include GARVEEs when calculating the State debt limit. **Insofar as rating agencies believe that GARVEEs should be included in State debt calculations, it is recommended that CDAC include GARVEEs in the State debt limit calculation. To effect this change, it is recommended that budget reconciliation legislation amend Section 8-104 of the State Finance and Procurement Article to clarify that GARVEE bonds are to be included in the CDAC’s calculation of State debt.**

5. State Should Reevaluate Debt Affordability Criteria to Determine How They Can Best Manage under the State’s Fiscal Condition

Chapter 43, Acts of 1978, created CDAC. The committee is required to recommend an estimate of a prudent GO bond authorization to the General Assembly and Governor. The committee’s 1979 report noted that it was created “[i]n response to a growing concern that the level of Maryland’s general obligation debt was high and rising.” Interestingly, the high level of growth was attributable to increased GO bond issuances for public school construction in the early 1970s.

To moderate State debt, the committee surveyed municipal finance specialists and developed criteria for evaluating debt affordability. To limit debt, the following criteria were established:

- debt outstanding should be limited to 3.2% of Maryland personal income;

X00A00 – Public Debt

- debt service should be limited to 8% of revenues supporting the debt service; and
- new authorizations are kept in the range of redemptions of existing debt. In other words, the State should not issue more than is being retired, ensuring the debt outstanding will not grow. This was referred to as the “get out of debt” criterion.

At the time the criteria were developed, the State exceeded the criteria. For example, the 1979 report estimates that fiscal 1980 would end with debt outstanding exceeding 5.4% of personal income and debt service exceeding 11.3% of revenues. When initially implemented, the goal of CDAC was to reduce the State’s debt burden. CDAC included the third criterion to ensure that the debt did not grow in the short-term. In fiscal 1986, debt outstanding to personal income fell below the 3.2% threshold, and in fiscal 1987 debt service to revenues fell below the 8% threshold. Subsequently, the third criterion was dropped. Specific reasons for eliminating the criterion are that:

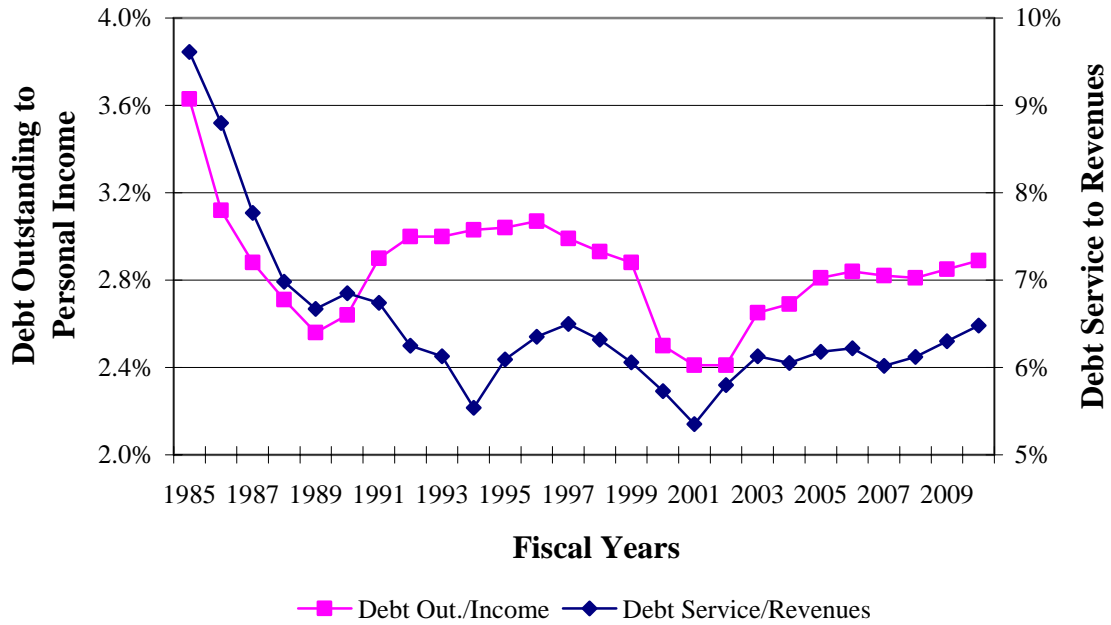
- the justification for the criterion, to reduce debt outstanding, was no longer a State goal;
- the criterion arbitrarily limits debt authorizations to actions that took place as much as 15 years ago; and
- the committee was concerned that the “get out of debt” criterion “became controlling over the short term.”

Debt Outstanding Is Now the Controlling CDAC Criterion

Since 1987, CDAC has used two criteria to evaluate affordability: (1) debt outstanding limited to 3.2% of personal income and (2) debt service limited to 8% of revenues. That year, the committee eliminated the “get out of debt” criterion.

Exhibit 16 shows that since fiscal 1986, when both criteria were first met, the State has been able to stay below both criteria in every year. Out-year forecasts project that the State will be able to maintain its ratios within the levels recommended by CDAC.

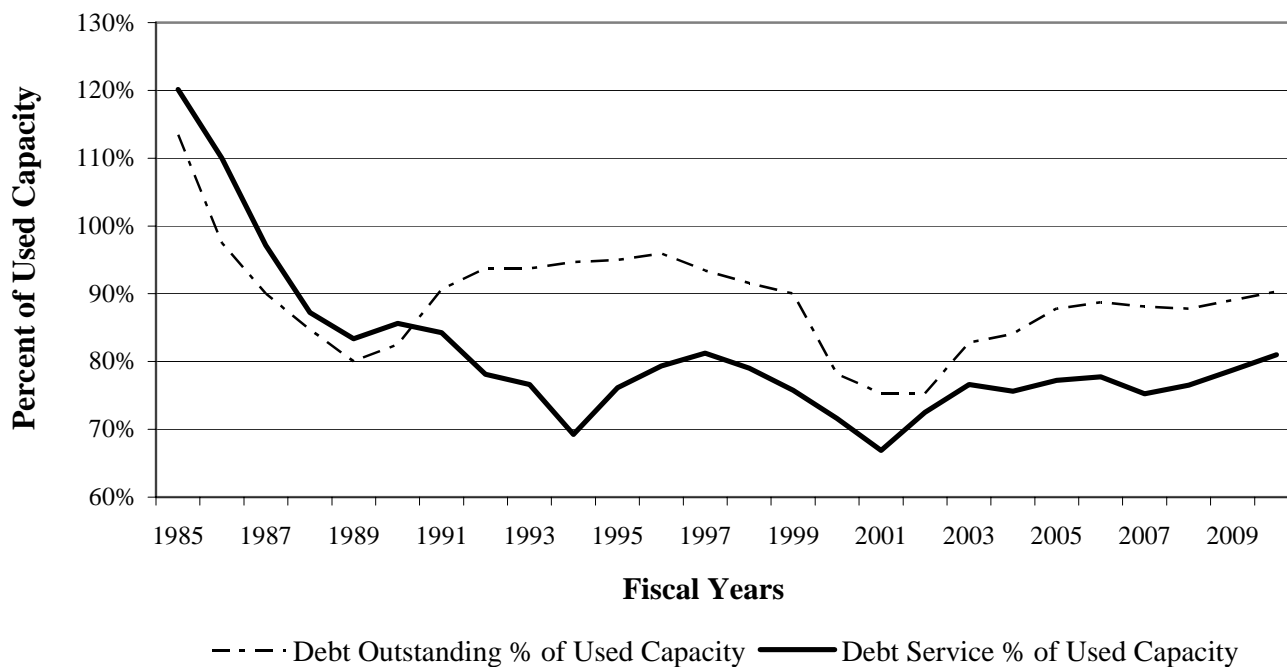
Exhibit 16
Capital Debt Affordability Committee
Debt Outstanding and Debt Service Criteria Performance
Fiscal 1985 to 2010



Source: Capital Debt Affordability Committee Reports

Over the last decade, the debt outstanding criterion has become the controlling criterion. **Exhibit 17** compares actual CDAC ratios with the limit (e.g., 3.2% of debt outstanding and 8% for debt service). If a ratio reaches 100%, it is at the limit. If it exceeds 100%, it exceeds the limit. The exhibit also shows that debt outstanding has been closer to capacity in every year since fiscal 1991. The capacity of debt service used peaked in fiscal 1996, when the debt service to actual personal income ratio used 96% of capacity.

Exhibit 17
Capital Debt Affordability Committee
Debt Outstanding and Debt Service – Percent of Used Capacity



Source: Capital Debt Affordability Committee Reports

The implication is that the debt service criterion has become the controlling criterion in every year since fiscal 1991. Given current estimates and the disparity between the unused capacities of the two criteria, it appears unlikely that this relationship will change any time soon. Similar to the “get out of debt” criterion in the late 1980s, the debt outstanding criterion has become controlling over the short-term.

CDAC Should Reevaluate Criteria to Determine If They Are Suited for the State’s Fiscal Condition

Since fiscal 2002, the State has had a structural deficit in the operating budget. To manage this structural deficit, property tax rates were raised in fiscal 2004. While property taxes are currently sufficient to support debt service, it is possible that either due to reduced property tax rates or new initiatives, property taxes may not be sufficient in the out-years. If this becomes the case, other State revenues would be needed to subsidize the ABF, which could widen the structural deficit in the operating budget.

X00A00 – Public Debt

The concern is that the CDAC criteria are not addressing the State’s most pressing fiscal problem. On the one hand, debt outstanding is the controlling CDAC criterion, and debt service is not a limiting factor. On the other hand, the State’s most pressing fiscal problem is the structural deficit, and with respect to debt, the problem is that the current revenue structure may not support debt service. This leads to the fundamental problem that CDAC could consider increased debt authorizations affordable even though there are no revenues identified to support debt service. **To address this issue, it is recommended that the following committee narrative be adopted:**

Reevaluation of State Debt Criteria: CDAC annually examines State debt needs and affordability. Based on its debt service and debt outstanding criteria, CDAC sets a debt limit. Under current conditions, the controlling criterion is managing to keep debt outstanding from exceeding 3.2% of State personal income. In 1986, when a particular criterion (at the time it was the “get out of debt criteria” which limited authorizations by the amount of debt retired) became the controlling criterion, the committee reevaluated its criteria and changed them to better reflect the State’s fiscal condition. Currently, the State is burdened with a long-term structural deficit. The concern is that the CDAC criteria do not pay sufficient attention to debt service requirements. To address this issue, CDAC should reevaluate the State’s debt affordability criteria. Its reevaluation should develop policies to:

- clarify when one of the criteria becomes the controlling criterion;
- provide for a process to reevaluate the criteria;
- adopt group of criteria that do not have a single controlling criterion;

CDAC should report on its findings and any policy changes attributable to the reevaluation in its annual report on recommended debt authorizations issued each September.

Recommended Actions

1. Adopt the following narrative:

Reevaluation of State Debt Criteria: The State’s Capital Debt Affordability Committee (CDAC) annually examines State debt needs and affordability. Based on its debt service and debt outstanding criteria, CDAC sets a debt limit. Under current conditions, the controlling criterion is managing to keep debt outstanding from exceeding 3.2% of State personal income. In 1986, when a particular criterion (at the time it was the “get out of debt criteria” which limited authorizations by the amount of debt retired) became the controlling criterion, the committee reevaluated its criteria and changed them to better reflect the State’s fiscal condition. Currently, the State is burdened with a long-term structural deficit. The concern is that the CDAC criteria do not pay sufficient attention to debt service requirements. To address this issue, CDAC should reevaluate the State’s debt affordability criteria. Its reevaluation should develop policies to:

- clarify when one of the criteria becomes the controlling criterion;
- provide for a process to reevaluate the criteria; and
- adopt group of criteria that do not have a single controlling criterion.

CDAC should report on its findings and any policy changes attributable to the reevaluation in its annual report on recommended debt authorizations issued each September.

Information Request	Author	Due Date
Reevaluation of CDAC debt criteria	Capital Debt Affordability Committee	September 2005

Current and Prior Year Budgets

Current and Prior Year Budgets Public Debt (\$ in Thousands)

	<u>General Fund</u>	<u>Special Fund</u>	<u>Federal Fund</u>	<u>Reimb. Fund</u>	<u>Total</u>
Fiscal 2004					
Legislative Appropriation	\$0	\$532,819	\$0	\$0	\$532,819
Deficiency Appropriation	0	0	0	0	0
Budget Amendments	0	4,000	0	0	4,000
Cost Containment	0	0	0	0	0
Reversions and Cancellations	0	0	0	0	0
Actual Expenditures	\$0	\$536,819	\$0	\$0	\$536,819
Fiscal 2005					
Legislative Appropriation	\$0	\$560,360	\$0	\$0	\$560,360
Budget Amendments	0	624,480	0	0	624,480
Working Appropriation	\$0	\$1,184,840	\$0	\$0	\$1,184,840

Note: Numbers may not sum to total due to rounding.

X00A00 – Public Debt

Fiscal 2004

Fiscal 2004 actual expenditures totaled \$536.8 million. During the fiscal year, expenditures were increased from \$532.8 million. The increase is attributable to debt service costs exceeding expectations by \$4 million.

Fiscal 2005

The fiscal 2005 legislative appropriation was \$560.4 million. Budget amendments increased the appropriation to almost \$1.2 billion. The \$624.5 million increase consists of:

- \$631.1 million in bond refunding proceeds were appropriated into program X00A00.05 to purchase bond refunding SLGS;
- \$8.5 million reduced from program X00A00.01 attributable to fiscal 2005 savings related to the bond refunding; and
- \$1.9 million in additional debt service costs attributable to increasing the total bonds sold in July 2004 from \$325 million to \$400 million.

**Fiscal Summary
Public Debt**

<u>Program/Unit</u>	<u>FY04 Actual</u>	<u>FY05 Wrk Approp</u>	<u>FY06 Allowance</u>	<u>Change</u>	<u>FY05 - FY06 % Change</u>
01 Redemption and Interest on State Bonds	\$ 536,818,783	\$ 553,783,371	\$ 617,574,736	\$ 63,791,365	11.5%
05 Related Expenses on State Bonds	0	631,056,322	0	-631,056,322	-100.0%
Total Expenditures	\$ 536,818,783	\$ 1,184,839,693	\$ 617,574,736	-\$ 567,264,957	-47.9%
Special Fund	\$ 536,818,783	\$ 1,184,839,693	\$ 617,574,736	-\$ 567,264,957	-47.9%
Total Appropriations	\$ 536,818,783	\$ 1,184,839,693	\$ 617,574,736	-\$ 567,264,957	-47.9%

Note: The fiscal 2005 appropriation does not include deficiencies, and the fiscal 2006 allowance does not reflect contingent reductions.

**Annual State Property Tax Savings for Homeowners
Effect of Reducing Property Tax Rate One Cent
From \$0.132 to \$0.122 per \$100 of Assessable Base**

<u>Home Value</u>	<u>Current Assessment</u>	<u>Proposed Assessment</u>	<u>Savings</u>
\$100,000	\$132	\$122	\$10
200,000	264	244	20
300,000	396	366	30
400,000	528	488	40
500,000	660	610	50
600,000	792	732	60
700,000	924	854	70
800,000	1,056	976	80
900,000	1,188	1,098	90
1,000,000	1,320	1,220	100
1,100,000	1,452	1,342	110
1,200,000	1,584	1,464	120
1,300,000	1,716	1,586	130
1,400,000	1,848	1,708	140
1,500,000	1,980	1,830	150
1,600,000	2,112	1,952	160
1,700,000	2,244	2,074	170
1,800,000	2,376	2,196	180
1,900,000	2,508	2,318	190
2,000,000	2,640	2,440	200
2,100,000	2,772	2,562	210
2,200,000	2,904	2,684	220
2,300,000	3,036	2,806	230
2,400,000	3,168	2,928	240
2,500,000	3,300	3,050	250
2,600,000	3,432	3,172	260
2,700,000	3,564	3,294	270
2,800,000	3,696	3,416	280
2,900,000	3,828	3,538	290
3,000,000	3,960	3,660	300

Source: Department of Legislative Services, February 2005

**Annual State Property Tax Savings for Homeowners
Effect of Reducing Property Tax Rate to Fiscal 2003 Level
From \$0.132 to \$0.084 per \$100 Assessable Base**

<u>Home Value</u>	<u>Current Assessment</u>	<u>Proposed Assessment</u>	<u>Savings</u>
\$100,000	\$132	\$84	\$48
200,000	264	168	96
300,000	396	252	144
400,000	528	336	192
500,000	660	420	240
600,000	792	504	288
700,000	924	588	336
800,000	1,056	672	384
900,000	1,188	756	432
1,000,000	1,320	840	480
1,100,000	1,452	924	528
1,200,000	1,584	1,008	576
1,300,000	1,716	1,092	624
1,400,000	1,848	1,176	672
1,500,000	1,980	1,260	720
1,600,000	2,112	1,344	768
1,700,000	2,244	1,428	816
1,800,000	2,376	1,512	864
1,900,000	2,508	1,596	912
2,000,000	2,640	1,680	960
2,100,000	2,772	1,764	1,008
2,200,000	2,904	1,848	1,056
2,300,000	3,036	1,932	1,104
2,400,000	3,168	2,016	1,152
2,500,000	3,300	2,100	1,200
2,600,000	3,432	2,184	1,248
2,700,000	3,564	2,268	1,296
2,800,000	3,696	2,352	1,344
2,900,000	3,828	2,436	1,392
3,000,000	3,960	2,520	1,440

Source: Department of Legislative Services, February 2005