

**X00A00  
Public Debt**

***Operating Budget Data***

(\$ in Thousands)

	<u>FY 08 Actual</u>	<u>FY 09 Working</u>	<u>FY 10 Allowance</u>	<u>FY 09-10 Change</u>	<u>% Change Prior Year</u>
General Fund	\$29,349	\$0	\$0	\$0	
<b>Adjusted General Fund</b>	<b>\$29,349</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	
Special Fund	663,189	745,505	784,987	39,482	5.3%
<b>Adjusted Special Fund</b>	<b>\$663,189</b>	<b>\$745,505</b>	<b>\$784,987</b>	<b>\$39,482</b>	<b>5.3%</b>
<b>Adjusted Grand Total</b>	<b>\$692,539</b>	<b>\$745,505</b>	<b>\$784,987</b>	<b>\$39,482</b>	<b>5.3%</b>

- Debt service costs continue to climb, reflecting increased debt outstanding.
- Special funds generated from State property tax receipts and projected bond sale premiums are sufficient to support debt service costs. No general funds need to be appropriated in fiscal 2010.

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

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## *Analysis in Brief*

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### **Issues**

***State Revises Debt Limits:*** The Capital Debt Affordability Committee’s 2008 report revised the State’s debt limits. The limit on total State debt outstanding was increased from 3.2% of personal income to 4.0% of personal income. The issue reviews the debt affordability process and examines State debt policies. **The Treasurer should brief the committees on change in the State’s debt affordability limits.**

***Growth in Debt Service Costs Are Projected to Exceed Growth in Revenues:*** The State has been expanding debt authorizations since 2000. Economic conditions are likely to slow the growth in revenues supporting debt service. **The State Treasurer should be prepared to brief the committees on debt service costs.**

***Legislation Allowing the Treasurer to Invest State Fund Balances in State and Municipal Debt Is Introduced:*** The State Treasurer has the authority to issue variable rate debt. State law does not allow the Treasurer to repurchase State bonds if a remarketing fails. Legislation allowing the State to repurchase bonds has been introduced. **The Treasurer should brief the committees on the legislation.**

***Federal Stimulus Bill Includes Provisions That May Affect State Bonds:*** A federal economic stimulus bill has been introduced in the U.S. Congress. The bill has some provisions that may affect State and municipal bonds. **The Treasurer should brief the committee on those provisions.**

### **Recommended Actions**

1. Concur with Governor’s allowance.

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**Public Debt**

***Operating Budget Analysis***

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**Program Description**

There are two programs under Public Debt:

- debt service funds general obligation (GO) bonds' principal and interest payments. GO bonds support the State's general construction program, such as prisons, office buildings, higher education facilities, school construction, and mental health facilities. GO bond debt service payments are supported by the Annuity Bond Fund (ABF). ABF revenues include State property tax revenues and repayments from certain State agencies, subdivisions, and private organizations. General funds may subsidize debt service if these funds are insufficient; and
- related expenses on State bonds, such as arbitrage penalty payments.

**Performance Analysis: Factors Influencing General Obligation Bonds' True Interest Cost**

The interest rate that Maryland pays for the bonds it sells is referred to as the True Interest Cost (TIC). This rate is derived by calculating a bond's internal rate of return. The TIC is calculated at each bond sale, and the bidder with the lowest TIC is awarded the bid. This process awards the bonds to the lowest cost bid.

Financial literature provides information about factors that influence the TIC of State and municipal bond sales. The Department of Legislative Services (DLS) has estimated what factors influence the TIC Maryland receives on new GO bonds issued since 1991. The analysis has been updated since 2008 to include 3 series of taxable bonds issued in 2005 and 2006, in addition to the 37 tax-exempt bond sales. The complete analysis is provided in the *Effect of Long-term Debt on the Financial Condition of the State* prepared by DLS.

The least squares regression analysis is used to evaluate the factors that could influence the TIC. In all, over 30 independent variables were tested. Only the four listed above are statistically significant at the 5% confidence level and met other statistical tests. Other variables tested include Maryland gross State product to United States gross domestic product, State budget growth, size of bond sale, and use of financial advisor. **Exhibit 1** shows the results of the analysis. The equation estimates that these four statistically significant factors influence the TIC:

- ***Delphis Scale:*** The key variable is the Delphis Scale. This is an estimate of the market rate for AAA-rated State and municipal bonds.

**Exhibit 1**  
**Evaluating the Cost of General Obligation Bonds**  
**True Interest Cost Regression Equation Independent Variables**

<u>Ind. Variable</u>	<u>Coefficient</u>	<u>Std. Error</u>	<u>Beta</u>	<u>Sig.</u>	<u>Tolerance</u>	<u>Explanation</u>
Delphis Scale	0.972	0.017	1.121	0.000	0.703	Coefficient less than 1.0 suggests Maryland TIC is less than other AAA-rated bonds. Equation is almost 100% sure that the variable is significant.
MD PI/US PI	-0.892	0.290	-0.055	0.004	0.859	Negative coefficient suggests that as the Maryland economy strengthens, compared to other states, the TIC declines. Significant at the 1.0% confidence interval.
Call	0.082	0.038	0.046	0.035	0.621	Cost of a call is 0.082% (8 basis points). Range is 0.044 to 0.120%. Significant at 5.0% confidence interval.
Taxable Debt	1.402	0.059	0.513	0.000	0.590	Taxable debt adds 1.402% (140 basis points) to TIC. Equation is almost 100% sure that the variable is significant.
Constant	2.107	0.653	n/a	0.003	n/a	Y-intercept is appropriate.

Ind.: Independent

MD PI/US PI: Maryland Total Personal Income to the United States Personal Income

Sig.: Significance or confidence interval

Std.: Standard

Source: Department of Legislative Services, *Effect of Long-term Debt on the Financial Condition of the State*, November 2008

- **Ratio of Maryland Total Personal Income to the United States Total Personal Income:** The regression equation uses a ratio that compares state personal income to United States personal income. If the ratio increases, Maryland is doing relatively better than the rest of the United States and a GO bond issuance's TIC should tend to decline.
- **Call Provision:** A call is an option that allows the seller to retire debt early. This may be advantageous if interest rates decline below the rate the seller is paying. Consequently, buyers often require higher interest rates if an issuance includes a call provision.

- ***Taxable Debt:*** The State has also issued three taxable debt series. Since investors are required to pay federal income taxes on the interest earnings of taxable bonds, these bonds require a higher return and sell at a higher TIC.

### **Equation's Significance: The DLS Equation Can Be Used to Analyze State Debt Policies**

Ultimately, the value of any statistical equation is its practical use. Relevant statistical equations are those that can be used to analyze policy. This particular equation provides a tool to better evaluate current debt policy. Specific policies to evaluate include:

- ***Costs and Benefits Associated with Issuing Callable Bonds:*** Usually, the State has included a call provision in the GO bonds that are issued. This allows the State to refinance or refund debt when interest rates decline. Prior analyses have solely calculated the benefits associated with calling and refunding bonds but did not estimate the cost of issuing callable bonds. Since the equation estimates the cost of issuing callable bonds, a full comparison can be made. To estimate total costs associated with issuing callable bonds, DLS reviewed bonds issued between 1991 and 2000. During that period the State issued \$3,590.0 million in GO bonds, \$1,371.0 million of which was refunded. The Treasurer's Office advises that gross savings totaled \$69.5 million. Assuming the call premium estimated by the equation (0.08% or 8 basis points), the premium paid for issuing callable bonds is \$9.6 million and the net savings is \$59.9 million.
- ***Increased Costs Associated with Issuing Taxable Bonds:*** To reduce borrowing costs, the State issues tax-exempt GO bonds. However, federal laws limit the kinds of activities that the proceeds of tax-exempt bonds can support. For example, only a small percentage of the proceeds can support private use or private activities. To avoid issuing taxable debt, the State uses pay-as-you-go funds appropriated in the operating budget for programs that do not qualify for tax-exempt bonds. Because general funds were scarce, the State issued taxable bonds in March 2005 (\$25.0 million issued), July 2005 (\$20.0 million issued), and March 2006 (\$20.0 million issued). The DLS equation estimates that taxable bond sales' TIC was 1.40%, or 140 basis points, greater than tax-exempt debt with similar maturities. This premium adds \$3.1 million in debt service costs for the \$65.0 million issued. At the time of the bond sales, it was estimated that they increased borrowing costs by \$2.8 million. The bottom line is that two separate methodologies reckon that taxable debt increased the borrowing costs associated with \$65.0 million in taxable debt by approximately \$3.0 million.
- ***How Bay Restoration Bonds Compare to GO Bonds:*** On June 12, 2008, the Maryland Water Quality Financing Administration issued \$50 million in bay restoration bonds. The bonds, which are supported by the Bay Restoration Fee to fund upgrades to wastewater treatment plants, are considered to be State debt. This was the first issuance of bay bonds. DLS compared the true interest cost of the bay bonds to GO bonds sold since 1991. The sum of least squares regression is used to determine what variables are statistically significant. The only change to the GO bond analysis was to add data for the bay bond sale to the data series

and to include an independent variable for bay bonds in the equation. (The independent variable for the Delphis Scale assumes the rate for AA-rated bonds.) This resulted in only minor changes to the GO bond equation's statistics. For example, the standard error of the equation increased from 0.075 to 0.078. The statistical data suggests that the markets perceive bay bonds to be AA-rated and that the bay bonds factors are very much influenced by the same factors that affect Maryland GO bonds. This implies that bay bonds benefit from Maryland's financial strength and good credit.

- ***Policy Changes:*** Other policy changes may also be evaluated. For example, the Treasurer's Office proposes to issue retail bonds at the next bond sale. Statistical analysis may be used to evaluate cost differences.

## **Proposed Budget**

The fiscal 2010 allowance totals \$785.0 million. This is \$39.5 million (5.3%) greater than the fiscal 2009 working appropriation. The increase is attributable to higher GO bond authorizations and issuances in recent years resulting in more debt outstanding. The amount of new GO bonds issued increased from just over \$400.0 million annually in fiscal 2001 and 2002 to over \$700.0 million annually since fiscal 2005.

**Exhibit 2** shows the revenues that support the State's GO bond debt service. The primary revenue source is the State property tax, which is deposited into the ABF. The rate has been \$0.112 per \$100 of assessable base since fiscal 2007. When bonds sell at a premium, the premium is also deposited into the ABF. When ABF revenues are insufficient to support GO bond debt service payments, additional general funds are appropriated. In fiscal 2010, ABF revenues are projected to be sufficient to support GO bond sale debt service.

**Exhibit 2**  
**Revenues Supporting General Obligation Bond Debt Service**  
**Fiscal 2008-2010**  
**(\$ in Thousands)**

	<u>2008 Actual Expenditures</u>	<u>2009 Working Appropriation</u>	<u>2010 Allowance</u>
<b>General Fund Appropriations</b>	\$29,349	\$0	\$0
<b>Annuity Bond Fund Activity</b>			
Beginning Balance	\$38,748	\$38,333	\$48,464
Property Tax Receipts	625,710	701,019	749,983
Interest and Penalties on Property Taxes	2,403	1,500	1,500
Local Loan Repayments	1,416	1,312	623
Miscellaneous Receipts	578	250	250
Bond Premium	32,668	50,851	0
Transfer to Reserve	-38,333	-48,464	-15,834
<b>Total Special Funds Activity</b>	<b>\$663,189</b>	<b>\$744,799</b>	<b>\$784,987</b>
Adjustment to fiscal 2009 Appropriation <sup>1</sup>	\$0	\$705	\$0
<b>Special Fund Appropriations</b>	<b>\$663,189</b>	<b>\$745,505</b>	<b>\$784,987</b>
<b>Total Appropriations</b>	<b>\$692,539</b>	<b>\$745,505</b>	<b>\$784,987</b>
<b>Total Budgeted Debt Services Appropriations</b>	<b>\$692,539</b>	<b>\$745,505</b>	<b>\$784,987</b>
Less: Excess fiscal 2009 Appropriation <sup>1</sup>	\$0	\$705	\$0
<b>Projected Debt Service Expenditures</b>	<b>\$692,539</b>	<b>\$744,799</b>	<b>\$784,987</b>

<sup>1</sup> Attributable to actual costs of July 2008 general obligation bond sale.

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

Source: Department of Budget and Management, January 2009

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ABF revenues are sufficient to support debt service in fiscal 2009 because the State expects bonds sold in fiscal 2009 to realize a premium. **Exhibit 3** shows that the State expects to realize \$56.3 million in bond sales premiums in fiscal 2009, providing \$6.1 million for school construction projects.

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**Exhibit 3**  
**Use of Bond Sale Premiums Realized in Fiscal 2009**  
(\$ in Millions)

<u>Bond Sale Date</u>	<u>Premium</u> <sup>1</sup>	<u>Support Debt Service</u>	<u>Support Aging Schools Program</u>
July 16, 2008	\$36.7	\$36.7	\$0.0
Est. March 4, 2009	19.6	13.5	6.1
<b>Total</b>	<b>\$56.3</b>	<b>\$50.2</b>	<b>\$6.1</b>

<sup>1</sup> Net of cost of issuance.

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

Source: Department of Budget and Management, January 2009

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## ***Issues***

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### **1. State Revises Debt Limits**

To develop State debt policies and advise the Governor and General Assembly, the Capital Debt Affordability Committee (CDAC) was established by Chapter 43 of 1978. CDAC meets in public, has adopted affordability guidelines, and recommends GO bond levels each fall. Although the recommendation is neither binding for the Governor nor the General Assembly, they have adopted the level recommended by the committee in every capital budget. This year, the committee revised the affordability guidelines for the first time in 20 years and for the second time since they were first adopted.

In 1979, the committee adopted three criteria to evaluate affordability: State debt outstanding cannot exceed 3.2% of State personal income; State debt service cannot exceed 8.0% of State revenues; and new authorizations should be kept in the range of redemptions of existing debt. When the criteria were adopted, the State did not meet either the debt outstanding or debt service criterion. Debt outstanding was 5.4% of personal income, and debt service was 11.3% of revenues in fiscal 1979. By adopting a policy to limit authorizations by redemptions, the committee limited new authorizations. This criterion was referred to as the “get out of debt” criterion. The debt affordability process achieved the goal to reduce debt outstanding and debt service costs. By fiscal 1987, debt outstanding was less than 3.2% of personal income, and debt service was less than 8.0% of revenues.

In 1987, CDAC determined that the criterion limiting new authorizations to redemptions was no longer an applicable guideline. The goal of reducing debt had been met, and the committee’s objective was no longer to reduce debt, but rather to maintain a stable capital program. At the time, the high ratings of the State’s debt indicated that the existing level of debt and the planned increases were acceptable to the rating agencies. The criterion also tied annual authorizations to the amount of debt issued as much as 15 years before, thereby, producing highly variable bond authorizations which is inconsistent with a stable capital program. For these reasons, the committee dropped the criterion.

In the November 2008 report, the committee again recommended changing the affordability criteria. As it reviewed the criteria, the committee consulted with rating agencies, investment bankers, and its financial advisor. CDAC met in public a half dozen times in 2007 and 2008 to discuss debt policy and the criteria. The committee determined that targets of the two criteria were no longer appropriate and recommended revising the criteria so that:

- State debt outstanding not exceed 4% of State personal income; and
- State debt service not exceed 8% of State revenues.

No change was made to the limit on debt service and the debt outstanding limit was increased. By maintaining debt service at 8% of revenues, the new affordability policy does not increase the amount of tax resources that could support debt service. The policy does increase the amount of total debt that the State may issue. This total debt has been increasing in recent years as the State expanded GO bond authorizations and issued new kinds of debt that were not supported by the State’s general fund, such as bay restoration bonds and Grant Anticipation Revenue Vehicles.

## Evaluation of State Debt Policies

The Government Finance Officers Association (GFOA) has prepared *A Guide for Preparing a Debt Policy* (released in 1998) which provides the guidelines for evaluating debt policies. **Exhibit 4** shows that the State meets four of the five guidelines.

### Exhibit 4 Evaluation of State Debt Policies

<u>GFOA Guidelines</u>	<u>Evaluation</u>	<u>Comment</u>
A consistently applied debt policy.	Meets guideline	Since the Capital Debt Affordability Committee (CDAC) first adopted the affordability criteria 30 years ago, there have been only two changes. Rating agencies have consistently identified Maryland's adherence to the debt affordability policies when justifying the AAA rating.
Nevertheless, the policy should be sufficiently flexible to permit the government to take advantage of market conditions or respond to changing conditions.	Meets guideline	As the State's debt levels have changed, the committee has modified affordability criteria. The committee also sets annual debt limits which are adjusted based on the State's needs.
Debt policies should be formally submitted to and adopted by a jurisdiction's elected officials.	Meets guideline	The capital budget authorizations adopted by the General Assembly have been within the limits set by CDAC.
Compliance with outstanding debt or debt service limitations and other measures of affordability should be documented in the budget document, annual report, or other reports.	Meets guideline	The committee's meetings are in public, and the committee prepares a report each fall.
A policy of affordable levels of debt will be based on a government's financial condition, including trends in financial performance, service levels, the tax and revenue base, and the impact of debt on the financial outlook.	Does not meet guideline	As discussed in Issue 2, debt service costs are increasing at a greater rate than the revenues supporting them. This at a time when large general fund deficits are projected.

GFOA: Government Finance Officers Association

Source: Government Finance Officers Association's *A Guide for Preparing a Debt Policy*, released in 1998

**The Treasurer should brief the committees on change in the State's debt affordability limits.**

## 2. Growth in Debt Service Costs Are Projected to Exceed Growth in Revenues

Fiscal 2010 GO bond debt service costs total \$785 million, a 5.3% increase over fiscal 2009 costs. Debt service costs are projected to continue to grow as a result of increased GO bond authorizations. **Exhibit 5** shows that the State has expanded the GO bond program in each of the last eight legislative sessions except in 2005.

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### Exhibit 5 Actions Increasing General Obligation Bond Authorization 2001-2009 Legislative Sessions

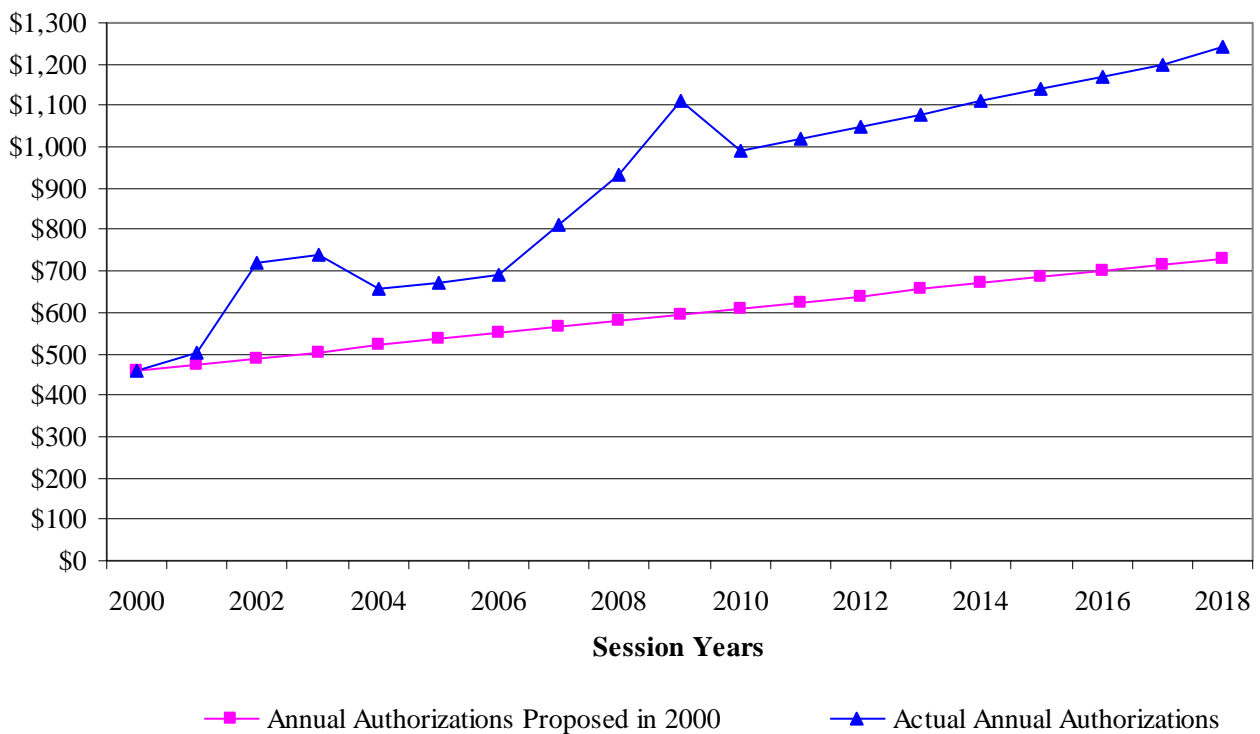
<u>Initial Authorization</u>	<u>Amount Authorized</u>	<u>Effect on Capital Spending</u>
Chapter 111 of 2001	\$30 million annually	Increase the State capital program
Chapter 103 of 2001	\$5 million annually	Fund Tobacco Transition Program
Chapter 290 of 2002	\$200 million in fiscal 2003	Move pay-as-you-go (PAYGO) capital projects into the general obligation (GO) bond program
Chapter 204 of 2003	\$200 million in fiscal 2004	Move PAYGO capital projects into GO bond program
Chapter 432 of 2004	\$100 million annually for five years	Increase the State capital program
Chapter 46 of 2006	Increase escalation from \$15 million to 3%, \$100 million annually, beginning in fiscal 2010	Increase the State capital program
Chapter 488 of 2007	\$100 million annually	Increase the State capital program
Chapter 336 of 2008	\$100 million annually	Increase the State capital program
SB 167/HB 102 of the 2009 session	\$150 million one-time increase	One-time authorization to fund capital supported by general fund

Source: *Effect of Long-term Debt on the Financial Condition of the State*, November 2008

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While each individual action may appear modest, the cumulative effect of these actions is substantial. In 2000, State policy was to increase GO bond debt by \$15 million annually. This would have led to a \$595 million GO program to be considered at the 2009 session. **Exhibit 6** shows that the 2009 session \$1,110 million authorization is \$515 million greater than planned in 2000.

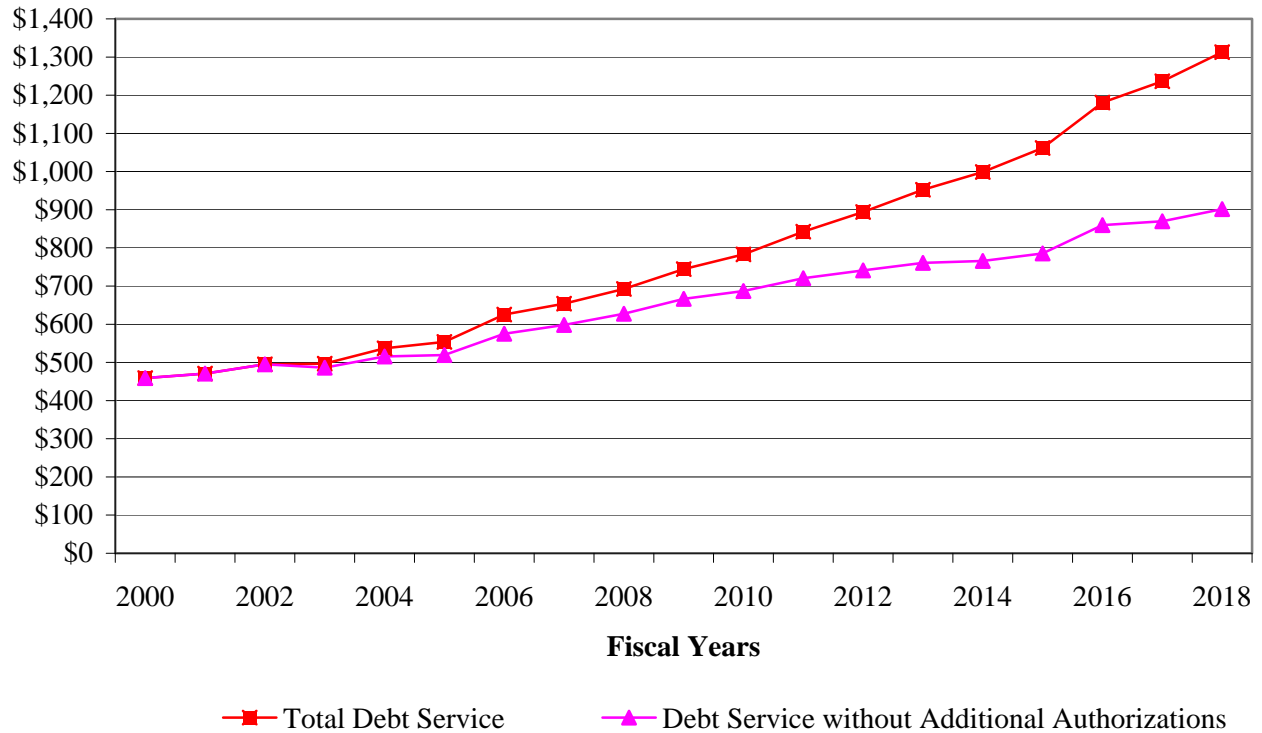
**Exhibit 6**  
**Increased General Obligation Bond Authorizations Since 2000**  
**2000-2018 Legislative Sessions**  
**(\$ in Millions)**



Source: *Effect of Long-term Debt on the Financial Condition of the State*, November 2008

These increased authorizations result in higher debt service costs. **Exhibit 7** shows that fiscal 2010 debt service costs are projected to have been \$687 million without the additional authorizations, which is \$98 million less than the current projection. From fiscal 2009 to 2014, debt service costs are projected to increase by 6.1% annually. Without the increased authorizations, the growth rate for GO bond debt service costs would have been an estimated 2.9% annually. By fiscal 2014, increased authorizations add \$233 million to debt service costs with debt service costs exceeding \$1.0 billion.

**Exhibit 7**  
**Effect of Increased General Obligation Bond Authorizations on**  
**Debt Service Costs**  
**Fiscal 2000-2018**  
**(\$ in Millions)**



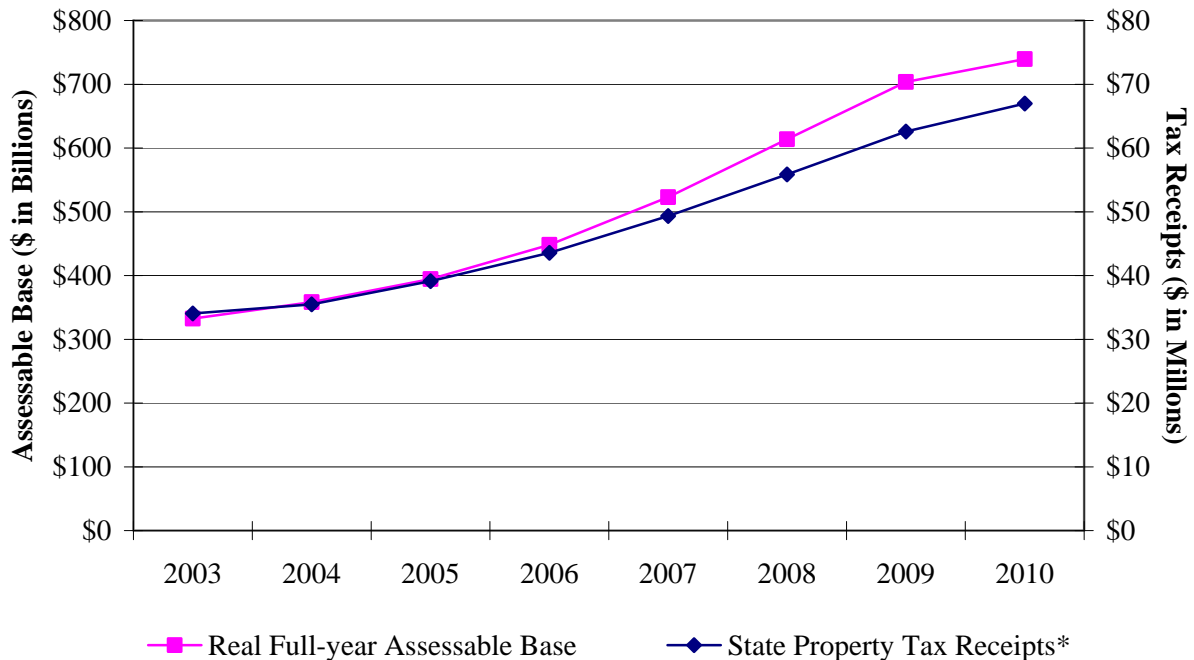
Source: *Effect of Long-term Debt on the Financial Condition of the State*, November 2008

### Annuity Bond Fund Revenues Expected to Grow Modestly

GO bond debt service costs are supported by the ABF. Historically, the fund's largest revenue source has been the State property tax. Other revenue sources include bond sale premiums, interest earnings generated by fund balances, and repayments for local bonds. When the ABF has not generated sufficient revenues to fully support debt service, general funds have subsidized debt service payments.

In recent years, increasing property values have led to strong growth in State property tax receipts. **Exhibit 8** shows that the State's full-year assessable base increased from \$333 billion in fiscal 2003 to \$740 billion in fiscal 2010.

**Exhibit 8**  
**Effect of Assessed Home Values on State Property Tax Collections**  
**Fiscal 2003-2010**



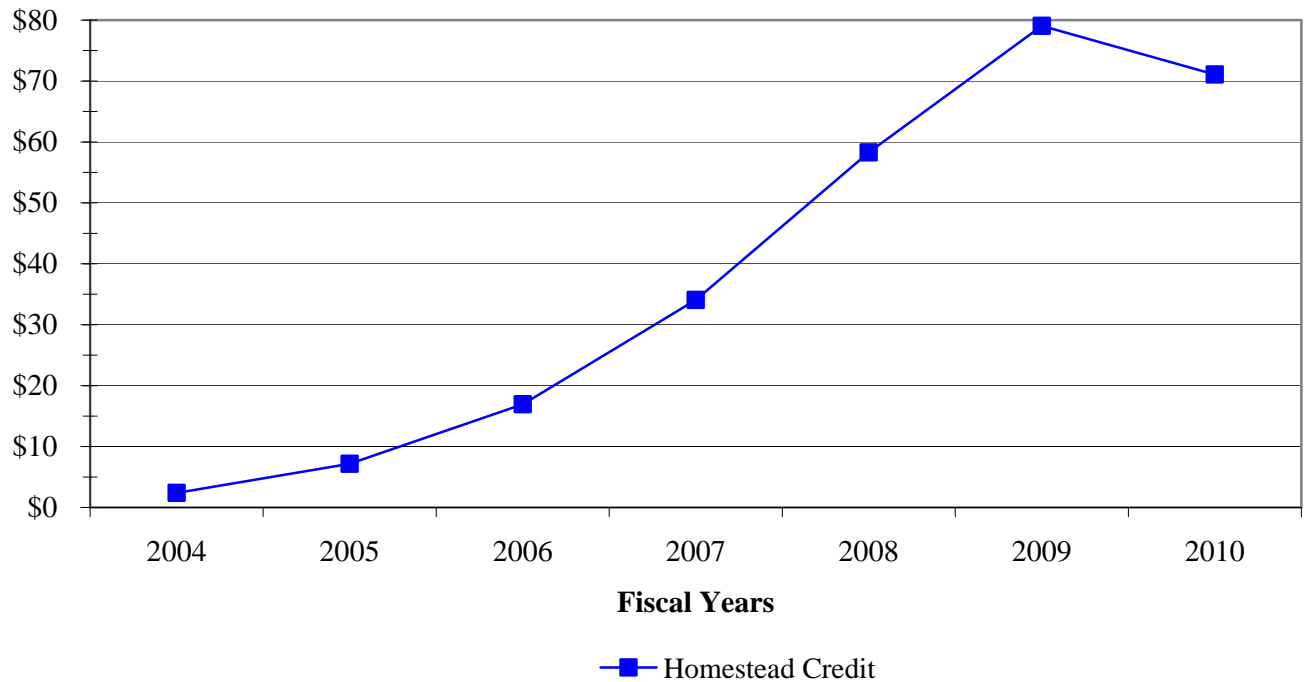
\* Adjusted to reflect collections for one cent on the State property tax rate.

Source: State Department of Assessment and Taxation; Department of Budget and Management

In response to increased assessments, State property tax collections also increased. However, the tax increase lagged the assessment increase primarily due to the homestead tax credit. This credit limits annual State tax increases to 10% over the prior year's tax bill. When assessments exceed 10%, the homeowner receives a credit for the amount exceeding 10%. **Exhibit 9** shows that homestead tax credits have increased from \$2.4 billion in fiscal 2004 to \$79.1 billion in fiscal 2009.

The homestead credit is the annual increase in residential property values in excess of 10%. When property values increase substantially, homestead credits slow the growth in taxes paid. If property values decline after a period of substantial growth, the homestead credit acts as a revenue hedge. As property values drop and assessments decline, the homestead credit is reduced. In many cases, individual tax bills continue to increase as home values decline. With respect to the ABF, the implication is that it is unlikely that State tax receipts are going to decline over the next few years. Rather, the homestead credit is likely to decline if home values continue to drop.

**Exhibit 9**  
**Homestead Tax Credit Reflects Changes in Real Estate Values**  
**Fiscal 2004-2010**  
**(\$ in Billions)**

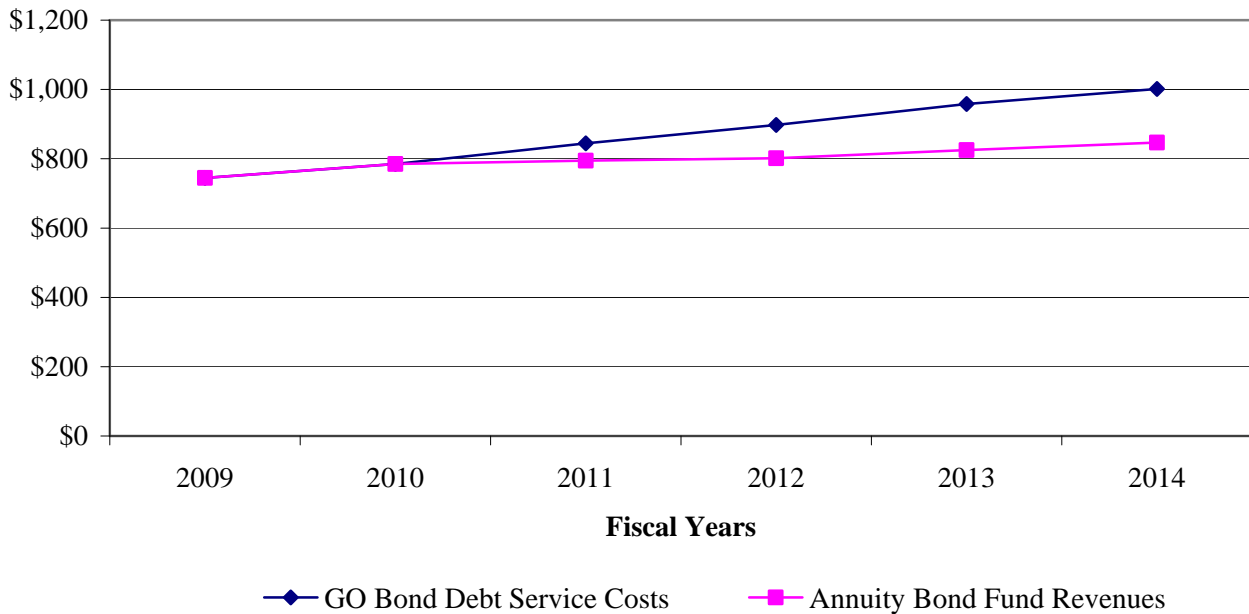


Source: State Department of Assessment and Taxation, November 2008

**Debt Service Costs Are Projected to Grow Faster Than Revenues**

Over the forecast period, debt service costs are projected to increase at a higher rate than the revenues supporting debt service costs. Higher GO bond authorizations result in debt service costs increasing 6.1% annually between fiscal 2009 and 2014. ABF revenues, which support GO bond debt service, are projected to grow by 2.6% annually over the same period. This reflects slowing growth in State property tax revenues, which account for over 95.0% of ABF revenues. **Exhibit 10** shows that costs are projected to exceed revenues in fiscal 2011. The gap increases from \$50 million in fiscal 2011 to \$155 million in fiscal 2014.

**Exhibit 10**  
**General Obligation Bond Debt Service Costs**  
**Exceed Annuity Bond Fund Revenues**  
**Fiscal 2009-2014**  
**(\$ in Millions)**



GO: general obligation

Source: Department of Budget and Management, January 2009

Most of this gap will need to be closed by adjusting revenues. Debt service costs represent past issuances which cannot be changed (except when bonds are refunded and called). To reduce debt service costs, the State could reduce the current session’s authorization. This does not yield any savings in the allowance and yields only limited savings thereafter. For example, reducing the current authorization by \$150 million (the one-time increase proposed by the CDAC), reduces fiscal 2011 debt service costs by \$3 million in fiscal 2011 and \$12 million in fiscal 2014. Deleting the entire 2009 session capital program reduces debt service costs by \$90 million in fiscal 2014, which is less than the \$155 million gap between revenues and costs.

Because debt service costs cannot be reduced, revenues will need to be increased. In the past, the State has subsidized debt service by appropriating general funds or by increasing State property tax rates. If general funds are not appropriated, State property tax rates will need to be increased from \$0.112 per \$100 of assessable base in fiscal 2010 to \$0.119 in fiscal 2011. By fiscal 2014, rates will need to be \$0.133 per \$100 of assessable base.

A concern is that the Department of Budget and Management’s out-year general fund forecast projects annual deficits well in excess of \$500 million. This means that funding the ABF deficit will require either reductions in operating budget spending or general fund tax increases if the State property tax is not increased. **The State Treasurer should be prepared to brief the committees on State GO bond debt service costs.**

### **3. Legislation Allowing the Treasurer to Invest State Fund Balances in State and Municipal Debt Is Introduced**

Chapter 235 of 2003 authorizes the State Treasurer to issue variable rate bonds. The law limits variable rate debt to 15% of the State’s outstanding GO bonds. There are different variable rate bond arrangements that may be entered into, such as Variable Rate Demand Bonds (VRDBs) and Commercial Paper. To date, the State has not issued variable rate bonds.

#### **Characteristics of Fixed and Variable Rate Bonds**

Maryland’s fixed rate bonds are 15-year agreements between the State and bondholders. The interest rate and maturity is set when the bonds are issued. The State guarantees specific debt service payments on specific days through the 15-year life of the bonds. Interest costs for fixed rate debt is, in part, a function of the 15-year life of the bonds. Because of the long-term nature of the bond, bondholders demand that the bonds provide a long-term interest rate, which is usually higher than the short-term rates.

Variable rate bonds do not have fixed interest rates throughout the life of the bond. Instead, VRDBs are issued with long nominal maturities that are constantly resold to lenders paying short-term interest rates. Unlike fixed rate bonds, VRDBs do not have an underwriter – instead a remarketing agent manages bond sales. Variable rate bonds are also not sold competitively which is impractical because the bonds are constantly remarketed. Traditionally, a Request for Proposal (RFP) is issued for the remarketing agent instead of issuing a Preliminary Official Statement.

#### **Variable Rate Bonds Need Liquidity Providers**

VRDBs also require a liquidity provider. Typically, variable rate debt is remarketed every week. If the remarketing agent cannot find another buyer for the debt, a liquidity provider is responsible for paying principal and interest for the bonds. Liquidity providers are usually banks with credit ratings of at least AA. Liquidity providers would also be competitively bid with an RFP. The Treasurer’s Office estimates that the cost of procuring a liquidity provider is \$250,000 annually for every \$100 million in variable rate debt.

An alternative to procuring a liquidity provider is to provide self-liquidity. Under such an arrangement, the State would need to pay the principal of the bonds if a remarketing fails.

## Legislation Allowing State to Provide Self-liquidity Is Introduced

If enacted, SB 610 would allow the State to provide its own liquidity in the case of a failed remarketing of GO bonds. The legislation does not allow the State to provide liquidity for non-GO bonds issued by other State agencies. The Treasurer's Office advises that the State would use cash reserves, which total approximately \$6 billion, should a GO bond remarketing fail. Current federal law requires that any bonds bought because of a failed remarketing need to be successfully remarketed as variable rate bonds or reissued as fixed rate bonds within 12 months. The legislation raises the following issues:

- ***Effect of Self-liquidity on Cash Position:*** By providing self-liquidity, the State may be forced to purchase its own variable rate GO bonds if a remarketing fails. The timing of this purchase would be determined by financial market conditions. The State may be required to purchase variable rate bonds at a time that is unfavorable to the State. While the State's current cash balance invested by the State Treasurer's Office of approximately \$6 billion appears to offer significant reserves, there are no guarantees that this will always be the case. The economy is currently in recession that shows no sign of abetting. Revenue projections may well be revised downward. A worst-case scenario would be if a remarketing fails at a time that the State does not have the available reserves to purchase the bond. **It is recommended that the General Assembly set limits on the investment portfolio's exposure to variable rate debt. The Treasurer should brief the committees on how this legislation would affect cash management policies and how these policies would guard against a negative cash balance.**
- ***Riskier Investments Are Allowed:*** The Treasurer's Office is only allowed to invest cash reserves in low-risk instruments, such as federal debt and short-term debt guaranteed by financial institutions with the highest ratings. Under current law, the Treasurer's Office does not have the authority to invest cash reserves in State and local government bonds. The bill allows the State to assist other State and local issuers by investing in their bonds. Though these issues are generally low-risk, this introduces additional risk in the investment portfolio. **It is recommended that the General Assembly require that any investments have the highest investment grade rating. The General Assembly should also consider setting limits on the amount of other State and local debt the investment portfolio may hold.**
- ***Transparency and Reporting Requirements:*** If the legislation is enacted and the State issues variable rate debt, additional risk would be introduced into the portfolio, and the State could be forced to purchase its own variable rate GO bonds. This is a significant departure from current practices that should be implemented transparently. **It is recommended that the General Assembly require that the Treasurer's Office report to the General Assembly on all State and local bond purchases as well as the State's cash position to the General Assembly.**

The Treasurer should brief the committees on Senate Bill 610 and the issues raised by the legislation.

#### 4. Federal Stimulus Bill Includes Provisions That May Affect State Bonds

In January, the American Recovery and Reinvestment Act (ARRA) was introduced in the U.S. House of Representatives. The bill attempts to provide the United States economy with a fiscal stimulus. The bill authorizes federal spending and reduces federal taxes. In addition, the bill includes provisions that affect State and municipal bonds. Since the bill has not yet been signed into law, it is subject to change. This issue addresses the bill in the current form.

##### Provisions That May Have a Substantial Impact

The following ARRA provisions could have a substantial impact:

- ***Extending and Increasing Qualified Zone Academy Bonds (QZABs):*** The State has \$42.0 million of QZABs outstanding. The bonds support education projects, such as the Aging Schools Program. Because they offer buyers federal tax credits, the bonds are less expensive than GO bonds. Assuming the same allocation formulas, this should result in an additional Maryland QZAB authorization of \$9.7 million per year for calendar 2009 and 2010. One concern about the bonds is that the Public School Construction Program has reported increasing difficulty in finding eligible “bricks and mortar” projects and in obtaining 10% private business matching contributions. The Treasurer’s Office is investigating using the bonds for noncapital projects, such as teacher training, course materials, test development, and charter schools. A second concern is that the market for these bonds is limited, and it is sometimes difficult to attract buyers. In the most recent bond sale, the State offered a 1.6% Supplemental Coupon to attract a buyer.
- ***Creating Qualified School Construction Bonds (QSCB):*** This creates a new category of bond support for construction, rehabilitation, or repair of public school facilities. Essentially creating federal tax credit bonds for construction projects, which would be similar to QZABs. There are two major issues: allocation of funds and difficulty attracting buyers (as with QZABs). At this point it is unclear how the funds will be distributed.
- ***Creating a Tax Credit Bond Option for State and Local Governments:*** The State could issue taxable bonds instead of tax-exempt bonds, and the federal government would make direct payments to the State equal to the federal tax credit that those bonds could have earned had they been issued as tax-exempt. It is not clear whether this option would apply to QSCBs, QZABs, or both. This is expected to make QZABs and QSCBs easier to market, which addresses a key issue related to these bonds.
- ***Creating or Modifying Other Tax Credit Bonds:*** Various incarnations of the bill relate to Recovery Zone Bonds (RZBs), Qualified Energy Conservation Bonds (QECBs), and Clean Renewable Energy Bonds (CREBs). RZBs are a new category of tax credit bonds for investment in economic recovery zones. Municipalities receiving an allocation of these bonds would be permitted to use these bonds to invest in infrastructure, job training, education, and economic development in areas within the boundaries of the State, city, or county that has

significant poverty, unemployment, or home foreclosures. QECBs are tax credit bonds that may be used to reduce greenhouse gas emissions. CREBs are tax credit bonds that may be used to finance renewable energy projects. As with other provisions, the State impact depends on the allocation and the marketability of the bonds.

### **Provisions That Are Expected to Have Little or No Impact**

The following ARRA provisions are expected to have little or no impact on Maryland bonds:

- ***De Minimis Safe Harbor Exception for Tax-exempt Interest Expense for Financial Institutions:*** Under current law, financial institutions are not allowed to take a deduction for the portion of their interest expense that is allocable to such institution’s investments in tax-exempt municipal bonds. In determining the portion of interest expense that is allocable to investments in tax-exempt municipal bonds, the bill would exclude investments in tax-exempt municipal bonds issued during 2009 and 2010 to the extent that these investments constitute less than 2% of the average adjusted bases of all the assets of the financial institution. The provision makes State and local bonds more marketable. ***Insofar as Maryland has no trouble attracting buyers, this would have little or no impact.***
- ***Modification of Small Issuer Exception to Tax-exempt Interest Expense Allocation Rules for Financial Institutions:*** As described above, financial institutions are not allowed to take a deduction for the portion of their interest expense that is allocable to such institution’s investments in tax-exempt municipal bonds. For purposes of this interest disallowance rule, bonds that are issued by “qualified small issuers” are not taken into account as investments in tax-exempt municipal bonds. Under current law, a “qualified small issuer” is defined as any issuer that reasonably anticipates that the amount of its tax-exempt obligations (other than certain private activity bonds) will not exceed \$10 million. The bill would increase this dollar threshold to \$30 million when determining whether a tax-exempt obligation issued in 2009 and 2010 qualifies for this small issuer exception. The small issuer exception would also apply to an issue if all of the ultimate borrowers in such issue would separately qualify for the exception. This makes State and local bonds more marketable. ***Insofar as Maryland has no trouble attracting buyers, this would have little or no impact.***
- ***Eliminate Costs Imposed on State and Local Governments by the Alternative Minimum Tax:*** The alternative minimum tax (AMT) can increase the costs of issuing tax-exempt private activity bonds imposed on State and local governments. Under current law, interest on tax-exempt private activity bonds is generally subject to the AMT. This limits the marketability of these bonds and, therefore, forces State and local governments to issue these bonds at higher interest rates. Last year, Congress excluded one category of private activity bonds (*i.e.*, tax-exempt housing bonds) from the AMT. The bill would exclude the remaining categories of private activity bonds from the AMT if the bond is issued in 2009 or 2010. ***There is no effect on State GO bonds but is expected to benefit State and local issuers of private activity bonds by making private activity bonds more attractive to investors.***

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- ***Repeal 3% Withholding on Government Contractors:*** For payments made after December 31, 2010, current law requires withholding at a 3% rate on certain payments to persons providing property or services made by federal, State, and local governments. The withholding is required regardless of whether the government entity making the payment is the recipient of the property or services (those with less than \$100 million in annual expenditures for property or services are exempt). Numerous government entities and taxpayers have raised concerns about the application of this provision. The legislation delays or repeals this law. ***This would positively affect the State’s contracting and help to hold down contracting costs but is not expected to affect the cost or marketability of Maryland bonds.***

**The Treasurer should brief the committees on the effect of the federal stimulus bill on Maryland’s bond program.**

## ***Recommended Actions***

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1. Concur with Governor's allowance.

## *Current and Prior Year Budgets*

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### 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>
<b>Fiscal 2008</b>					
Legislative Appropriation	\$29,349	\$663,346	\$0	\$0	\$692,695
Deficiency Appropriation	0	0	0	0	0
Budget Amendments	0	0	0	0	0
Cost Containment	0	0	0	0	0
Reversions and Cancellations	0	-156	0	0	-156
<b>Actual Expenditures</b>	<b>\$29,349</b>	<b>\$663,189</b>	<b>\$0</b>	<b>\$0</b>	<b>\$692,539</b>
<b>Fiscal 2009</b>					
Legislative Appropriation	\$0	\$745,505	\$0	\$0	\$745,505
Cost Containment	0	0	0	0	0
Budget Amendments	0	0	0	0	0
<b>Working Appropriation</b>	<b>\$0</b>	<b>\$745,505</b>	<b>\$0</b>	<b>\$0</b>	<b>\$745,505</b>

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

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**Fiscal Summary  
Public Debt**

<u>Program/Unit</u>	<u>FY08 Actual</u>	<u>FY09 Wrk. Approp.</u>	<u>FY10 Allowance</u>	<u>Change</u>	<u>FY09 - FY10 % Change</u>
01 Redemption and Interest on State Bonds	\$ 692,538,597	\$ 745,504,660	\$ 784,986,995	\$ 39,482,335	5.3%
<b>Total Expenditures</b>	<b>\$ 692,538,597</b>	<b>\$ 745,504,660</b>	<b>\$ 784,986,995</b>	<b>\$ 39,482,335</b>	<b>5.3%</b>
General Fund	\$ 29,349,121	\$ 0	\$ 0	\$ 0	0.0%
Special Fund	663,189,476	745,504,660	784,986,995	39,482,335	5.3%
<b>Total Appropriations</b>	<b>\$ 692,538,597</b>	<b>\$ 745,504,660</b>	<b>\$ 784,986,995</b>	<b>\$ 39,482,335</b>	<b>5.3%</b>

Note: The fiscal 2009 appropriation does not include deficiencies. The fiscal 2010 allowance does not include contingent reductions.