

**X00A00  
Public Debt**

***Operating Budget Data***

(\$ in Thousands)

	<u>FY 10 Actual</u>	<u>FY 11 Working</u>	<u>FY 12 Allowance</u>	<u>FY 11-12 Change</u>	<u>% Change Prior Year</u>
Special Fund	\$776,666	\$834,344	\$867,350	\$33,006	4.0%
FY2011 Cost Containment	0	0	0	0	
Contingent & Back of Bill Reductions	0	0	0	0	
<b>Adjusted Special Fund</b>	<b>\$776,666</b>	<b>\$834,344</b>	<b>\$867,350</b>	<b>\$33,006</b>	<b>4.0%</b>
Federal Fund	857	7,640	11,060	3,421	44.8%
FY2011 Cost Containment	0	0	0	0	
Contingent & Back of Bill Reductions	0	0	0	0	
<b>Adjusted Federal Fund</b>	<b>\$857</b>	<b>\$7,640</b>	<b>\$11,060</b>	<b>\$3,421</b>	<b>44.8%</b>
<b>Adjusted Grand Total</b>	<b>\$777,523</b>	<b>\$841,984</b>	<b>\$878,410</b>	<b>\$36,427</b>	<b>4.3%</b>

- The budget includes a \$1.6 million deficiency appropriation. These are federal funds that support debt service payments. The budget also withdraws \$6.8 million in Program Open Space transfer tax revenues appropriated for debt service payments. Actual debt service payments are less than anticipated, so the funds are withdrawn by the Administration.
- Debt service costs continue to climb, reflecting increased debt outstanding.
- Special funds generated from State property tax receipts and bond sale premiums are sufficient to support debt service costs in fiscal 2012. No general fund appropriation is needed.

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

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## *Analysis in Brief*

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### Issues

***To Reflect New Austerity, Modifications to the Debt Affordability Process Are Recommended:*** This issue examines the implications of the increase in debt over the last decade and analyzes potential issues associated with being at the debt limit. **To reflect that the State is at the debt limit, legislation to modify the State debt affordability process is recommended.**

***Revised State Property Tax Revenues Are Projected to Be Insufficient to Support Debt Service in the Out-years:*** From fiscal 2011 to 2015, debt service costs are estimated to increase by 5.5% annually while the State property tax revenues that support debt service are expected to decline. A general fund subsidy totaling \$132 million is expected in fiscal 2013. The subsidy increases to \$398 million by fiscal 2016. **The State Treasurer’s Office should brief the committees on the out-year Annuity Bond Fund forecast. This should include a discussion of how bond rating agencies perceive the State’s long-term fiscal condition.**

***Will the State Be Issuing Taxable Bonds Soon?*** Data from recent bond sales show that taxable debt is more expensive than tax-exempt debt. In fiscal 2011, the State increased bond authorizations for private purpose projects. This could require the State to issue taxable debt. **The State Treasurer’s Office should brief the committees on the level of proposed bond authorizations that are subject to private purpose restrictions. This should include a discussion of the likelihood, timing, and amount of any taxable debt issuance.**

***Update on American Recovery and Reinvestment Bonds:*** The federal fiscal stimulus includes provisions to issue different kinds of debt. This includes Qualified Energy Conservation Bonds, which could support the State’s Energy Performance Contracts. **The State Treasurer’s Office should brief the committees on the use of these bonds. This should include a discussion of their marketability.**

### Recommended Actions

1. Concur with Governor’s allowance.

## X00A00 Public Debt

### *Operating Budget Analysis*

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#### **Program Description**

There are three 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;
- related GO bond expenses on State bonds, such as arbitrage penalty payments; and
- Program Open Space (POS) bond payments. Chapter 419 of 2009 authorized the issuance of up to \$70 million in POS bonds to finance land acquisition. The debt service is supported by transfer tax payments.

#### **Performance Analysis**

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 competitive 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 examines data from the 51 bond sales (refunding sales are excluded): 41 competitively bid, tax-exempt; 3 competitively bid, taxable GO bond sales; 4 competitively bid, Build America Bonds (BABs); and 3 negotiated, retail 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 sum of least squares regression analysis is used to evaluate the factors that could influence the TIC. In all, over 30 independent variables were tested, including Maryland gross State product to United States gross domestic product, State budget growth, average years to maturity, and use of a financial advisor. **Appendix 3** provides all the data for the statistically significant variables. **Exhibit 1** shows which 6 independent variables are statistically significant factors (at the 5% confidence level) that influence the TIC:

**Exhibit 1**  
**True Interest Cost Regression Equation Independent Variables**  
**Bond Sales from 1991 to 2010**

<u>Ind. Variable</u>	<u>Coefficient</u>	<u>Std. Error</u>	<u>Beta</u>	<u>t-test</u>	<u>Sig.</u>	<u>Tol.</u>	<u>Comment</u>
Delphis Scale	0.999	0.039	0.816	25.457	0.00	0.457	High t-test suggests confidence that the Delphis Scale is significant.
MD PI/US PI	-1.223	0.517	-0.060	-2.363	0.02	0.734	Negative coefficient suggests that as the Maryland economy strengthens, compared to the United States, the TIC declines.
Years to Maturity	0.348	.026	0.684	13.349	0.00	0.179	Positive coefficient suggests that longer maturities tend to have higher TICs.
Amount Sold	5.96x10 <sup>-10</sup>	0.000	0.071	2.435	0.02	0.553	Every \$100 million sold adds 0.06% (6 basis points) to the TIC.
Taxable Debt	2.733	0.164	0.636	16.678	0.00	0.323	Suggests taxable bonds are more expensive than traditional bonds.
BABs	-1.672	0.165	-0.445	-10.123	0.00	0.243	Negative coefficient suggests BABS bonds are less expensive.
Constant	4.206						

BABs: Build America Bonds

Ind.: Independent

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

Sig.: Significance or confidence interval

Std.: Standard

TIC: True interest cost

Tol.: Tolerance, a test of multicollinearity

Source: Department of Legislative Services, *Effect of Long-term Debt on the Financial Condition of the State*, November 2010

- ***Delphis Scale:*** The key variable is the Delphis Scale. This is an estimate of the market rate for AAA-rated state and municipal bonds.
- ***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.
- ***Taxable Debt:*** The State issued taxable bonds in March 2005 (\$25 million issued), July 2005 (\$20 million issued), and March 2006 (\$20 million issued). 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.
- ***Amount of Debt Sold:*** Issues that are particularly small or large can be more expensive. Smaller issues may be more difficult for underwriters to market and larger issues may be more difficult for the market to absorb. Since the coefficient is positive, Maryland's TIC increases as the amount of bonds sold increases. This is to be expected, since Maryland is a highly rated State that issues bonds in fairly large quantities; in other words, Maryland bonds are easy to market (because the debt is high-quality and well-known) but difficult to absorb (because the issuances are large).
- ***Build America Bonds:*** In February 2009, the American Recovery and Reinvestment Act of 2009 (ARRA) authorized the issuance of BABs. These are taxable bonds that support the same types of projects that traditional tax-exempt bonds support. The difference is that the buyers do not receive any federal tax credits or deductions so that the interest earnings are subject to federal taxes. Instead, Maryland receives a subsidy equal to 35% of the interest costs from the federal government. In concept, the bonds expand the number of buyers of State and municipal debt since they are also attractive to individuals and institutions that do not pay federal taxes. Because the tax-exempt bond benefit is greater for shorter maturities, the State issued tax-exempt bonds with shorter maturities and BABs with longer maturities. The analysis estimates that the State realized savings by issuing BABs instead of tax-exempt bonds.
- ***Years to Maturity:*** Under normal economic conditions, bonds with shorter maturities have lower interest costs than bonds with longer maturities. This is referred to as a positive yield curve. The analysis estimates that every year adds 0.35% (35 basis points) to the 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 evaluate current debt policy.

### Build America Bonds Are Less Expensive Than Tax-exempt GO Bonds

Large sums of BABs have been issued by the State Treasurer’s Office, University System of Maryland, Maryland Transportation Authority, and municipalities. BPW issued \$583.2 million between August 2009 and July 2010. The BABs were issued in the place of tax-exempt bonds. The Treasurer’s Office estimated that BABs with longer maturities would be less expensive than tax-exempt bonds with longer maturities. Consequently, BABs were issued with longer maturities, and tax-exempt bonds were issued for the shorter maturities. The actual costs of these four blended sales are compared to an estimate of the cost of tax-exempt bonds sold on the same day. The regression equation is used to determine the TIC of similarly sized issuances of tax-exempt bonds for each BAB issuance. This estimate of tax-exempt bonds is then compared to the actual cost of the blended BAB issuance. **Exhibit 2** shows that the blended BABs sale saved the State \$38.8 million. The blended BABs debt service costs were \$41.2 million less than tax-exempt issuances, but this was offset by reducing the premium \$2.4 million.

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**Exhibit 2**  
**Estimated Cost Savings Associated with Build America Bonds**  
**(\$ in Millions)**

	<b>Debt Service Costs</b>	<b>Premium Realized</b>	<b>Total</b>
Actual Costs of Blended BABs and Tax-Exempt Issuances	\$399.0	-\$32.1	\$366.9
Projected Cost of Tax-exempt Only Issuances <sup>1</sup>	440.2	-34.5	\$405.7
Difference	-\$41.2	\$2.4	-\$38.8

<sup>1</sup> Costs were projected by estimating the True Interest Cost of a tax-exempt bond sale issuing an amount equivalent to the blended BABs sale on that day. The Department of Legislative Services’ regression equation is used to estimate the TIC. The analysis assumes a 5% coupon rate, which generates a premium.

Source: Department of Legislative Services, January 2011

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### 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 (PAYGO) funds appropriated in the operating budget for programs that do not qualify for tax-exempt bonds. Because general funds were scarce from fiscal 2004 to 2006, the State issued taxable bonds in fiscal 2005 and 2006. The analysis estimates that the TIC of taxable bonds is 2.73% (273 basis points) greater than the TIC for tax-exempt, 10-year bonds. Other factors that influence the TIC are the bonds’ maturity and amount issued. The implication is that by issuing fewer bonds with short maturities, the TIC can be reduced. In fact, the actual TIC of the

bonds was less because the Treasurer's Office issued taxable bonds in shorter maturities and small denominations. After adjusting for the shorter maturities and smaller number of bonds sold, the premium that the State paid for taxable bonds is estimated to be 1.65%, or 165 basis points, greater than tax-exempt debt with similar maturities. DLS estimates that taxable bonds added \$2.8 million in debt service costs for the \$65.0 million issued.

### **Smaller Issuances Are Less Expensive Than Larger Issuances**

Since 1991, Maryland has issued bonds 51 times. Bond sales vary from \$20 million to \$500 million with an average size of \$211 million, a median size of \$200 million, and a standard deviation of approximately \$122 million. The DLS analysis estimates that increasing the size of a bond sale \$100 million increases the sale's TIC by 0.0596% (6 basis points). This increases annual debt service costs by just under \$5,960 for every \$100 million sold. The implication is that the State can reduce borrowing costs by reducing the amount of bonds sold on occasion and increasing the number of bond sales. Because the additional costs attributable to increased bond sales are quite modest, increasing the number of bond sales may result in additional costs that offset savings if the State were to issue more bonds.

## **Fiscal 2011 Actions**

### **Proposed Deficiencies**

The budget bill includes two fiscal 2011 deficiency appropriations: \$1.6 million in additional federal funds appropriated to the ABF to support federal tax subsidy bonds' debt service costs; and \$6.8 million in special fund appropriations withdrawn from a Revenue Debt account for POS bonds. In previous years, fund changes would not necessarily have been appropriated in the budget bill; instead, the practice was to appropriate these funds by budget amendment. The appropriations are included in the bill to satisfy a request by the General Assembly to appropriate special and federal funds in the budget bill instead of the budget amendment process, whenever possible.

### **Additional Federal Subsidies**

ARRA authorized the issuance of taxable bonds with federal subsidies. The best known of these bonds are BABs. The federal government reimburses the State for 35% of the interest payments. Qualified School Construction Bonds (QSCBs) and Qualified Zone Academy Bonds (QZABs) can also be issued as taxable bonds that receive a federal subsidy. The working appropriation includes \$7.6 million in federal funds supporting BAB issuances from July 2009, October 2009, and February 2010. Since the budget was enacted in April 2010, the State issued BABs in July 2010, QSCBs in July 2010, and QZABs in December 2010. The deficiency appropriation is the federal fund subsidy for these issuances. **It is recommended that the General Assembly approve the federal funds.**

## **Program Open Space Bonds**

POS bonds totaling \$70 million were authorized as the Program Open Space Acquisition and Opportunity Loan of 2009 (Chapter 419 of 2009). The bonds were intended to backfill the transfer of up to \$70 million in the POS State share unencumbered fund balance per the Budget Reconciliation and Financing Act of 2009 (Chapter 487 of 2009). The law requires that debt service on POS bonds' debt service be paid from the POS land acquisition allocation of the State transfer tax.

In 2010, it was anticipated that the full \$70.0 million in special bonds would be issued in spring 2010. The bonds had to be issued by June 2010 because they needed to be issued within one year of the first general fund advances for property purchases, which were approved by the Board of Public Works (BPW) on June 17, 2009. The allowance included \$6.8 million appropriated to a newly created Revenue Debt account for fiscal 2011 debt service costs on POS bonds. The estimate assumed a 15-year maturity, principal payments after 1 year, and a 5% TIC.

Chapter 372 of 2010 amended the authorization to authorize BPW to issue GO bonds and have transfer tax revenues support the debt service. The Treasurer's Office concluded that issuing new POS bonds would be more expensive than GO bonds and issued GO bonds instead. The proceeds from the July 2010 GO bond sales support POS. The first year's debt service payment totals \$1.2 million in fiscal 2011. Debt service costs increase to \$6.1 million in 2014 and total \$86.7 million through fiscal 2026.

The deficiency removes the entire \$6.8 million that had been appropriated to the Revenue Debt account. The Administration proposes to transfer \$1.2 million of transfer tax revenues into ABF for debt service for GO bonds supporting POS. All DLS estimates in this analysis assume that transfer tax revenues will support debt service payments for GO bonds supporting POS payments. Since this is a withdrawn appropriation, the legislature cannot remove the appropriation.

## **Proposed Budget**

The fiscal 2012 allowance totals \$878.4 million. This continues the steady increase in GO bond debt service costs experienced in recent years. These increases are attributable to higher GO bond authorizations and issuances in recent years resulting in more debt outstanding. For example, 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.

The fiscal 2012 allowance supports GO and POS bond debt service. Total expenditures increase from \$842.0 million in fiscal 2011 to \$878.4 million in fiscal 2012. The working appropriation includes \$6.8 million for POS bond debt service payments that are deleted in a deficiency appropriation. **Exhibit 3** reconciles the appropriations in the fiscal 2011 working appropriation and allowance with projected expenditures. Fiscal 2011 costs are expected to be \$834.8 million, instead of the \$842.0 million in the working appropriation. Costs are lower because projected GO bond costs are \$3.1 million less than projected and POS bond debt service costs are

**Exhibit 3**  
**General Obligation Bond Debt Service Revenues and Appropriations**  
**Fiscal 2010-2012**  
**(\$ in Thousands)**

	<b>FY 2010 Actual <u>Expenditures</u></b>	<b>FY 2011 Working <u>Appropriation</u></b>	<b>FY 2012 <u>Allowance</u></b>
<b>Annuity Bond Fund Activity</b>			
Beginning Balance	\$71,277	\$105,315	\$129,794
Property Tax Receipts	742,884	799,869	761,680
Interest and Penalties on Property Taxes	3,185	1,500	1,500
Local Loan Repayments	892	626	477
Miscellaneous Receipts	523	250	250
Bond Premium	63,221	46,655	9,521
Transfer to Reserve	-105,315	-129,794	-37,433
<b>ABF Special Fund Appropriations</b>	<b>\$776,666</b>	<b>\$824,421</b>	<b>\$865,789</b>
<b>Transfer Tax Revenues</b>	<b>\$0</b>	<b>\$1,209</b>	<b>\$1,561</b>
<b>Federal Fund Appropriations</b>	<b>\$857</b>	<b>\$9,202</b>	<b>\$11,060</b>
<b>Projected Total Debt Service Expenditures</b>	<b>\$777,523</b>	<b>\$834,833</b>	<b>\$878,410</b>
<b>Fiscal 2011 Changes to Legislative Appropriation</b>			
Excess Fiscal 2011 Appropriation	\$0	\$3,122	\$0
Reduced POS Appropriations	0	6,800	0
POS Bonds' Debt Service	0	-1,209	0
Additional Federal Funds	0	-1,562	0
<b>Total Changes</b>	<b>\$0</b>	<b>\$7,151</b>	<b>\$0</b>
<b>Budgeted Debt Service Appropriations</b>	<b>\$777,523</b>	<b>\$841,984</b>	<b>\$878,410</b>

ABF: Annuity Bond Fund  
POS: Program Open Space

Source: Department of Budget and Management, January 2011

reduced by the \$6.8 million deficiency appropriation. These costs are offset by actual POS debt service costs totaling \$1.2 million and federal funds totaling \$1.6 million. Making these adjustments result in projected fiscal 2011 spending totaling \$834.8 million. The lower spending results in a higher end-of-year ABF balance.

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The exhibit also shows that the primary revenue source is the State property tax. 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 2012, ABF revenues are projected to be sufficient to support GO bond sale debt service.

**Exhibit 4** provides a breakdown of debt service costs projected in the fiscal 2012 allowance. The allowance includes \$850.5 million in debt service from bonds that have already been issued and \$27.9 million on debt service from issuances projected in February and July of 2011. Prior to fiscal 2001, the State debt service was traditional GO bonds (tax-exempt debt issued to institutional investors). The exhibit identifies debt service payments attributable to the new kinds of debt that have been added since 2001.

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**Exhibit 4**  
**Fiscal 2012 GO Bond Debt Service Costs**  
**(\$ in Millions)**

<u>Type of Debt</u>	<u>Principal</u>	<u>Interest</u>	<u>Sinking Fund</u>	<u>Total</u>
<b>Previously Issued Debt</b>				
Traditional GO Bonds <sup>1</sup>	\$533.0	\$257.7	\$0.0	\$790.7
Build America Bonds	0.0	25.3	0.0	25.3
Retail Bonds	0.0	12.1	0.0	12.1
Taxable Bonds	8.3	0.7	0.0	9.1
Qualified Zone Academy Bonds	0.8	0.4	2.2	3.4
Qualified School Construction Bonds	0.0	2.0	6.4	8.3
Program Open Space Bonds	0.0	1.6	0.0	1.6
<b>Subtotal</b>	<b>\$542.2</b>	<b>\$299.7</b>	<b>\$8.6</b>	<b>\$850.5</b>
<b>Projected Issuances</b>				
February 2011 Bond Sale	\$0.0	\$15.5	\$0.0	\$15.5
July 2011 Bond Sale	0.0	12.4	0.0	12.4
<b>Subtotal</b>	<b>\$0.0</b>	<b>\$27.9</b>	<b>\$0.0</b>	<b>\$27.9</b>
<b>Total</b>	<b>\$542.2</b>	<b>\$327.7</b>	<b>\$8.6</b>	<b>\$878.4</b>

<sup>1</sup> Tax-exempt bonds sold to institutional investors.

GO: general fund

Source: Comptroller's Office and Treasurer's Office

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## *Issues*

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### **1. To Reflect New Austerity, Modifications to the Debt Affordability Process Are Recommended**

State debt includes GO bonds, Maryland Department of Transportation's (MDOT) transportation bonds, Grant Anticipation Revenue Vehicles (GARVEEs) capital leases supported by State revenues, Stadium Authority bonds supported by State revenues, and bay restoration bonds. To manage this State debt, the Capital Debt Affordability Committee (CDAC) was created in 1978. The committee sets limits on GO bond issuances. The committee also evaluates the affordability of all State debt. CDAC has two affordability criteria: State debt outstanding cannot exceed 4% of State personal income; and State debt service cannot exceed 8% of State revenues.

Capital programs supported by State debt have evolved. Over the last decade, the State has increased debt authorizations to expand capital spending and to shift funding of capital projects from PAYGO to debt. The State has now reached the affordability limit. After years of increasing authorizations, the GO bond authorization decreases from \$1,140 million in fiscal 2011 to \$925 million in fiscal 2012. **Because a reduction in GO bond authorizations is necessary to keep debt ratios within affordability limits, DLS concurs with the recommendation to limit GO bond authorizations to \$925 million.**

The reduction in GO bond authorizations is a significant change to the capital program which confirms that, after 11 years of capital spending growth, the State is now facing a period of little or no capital spending growth. This issue:

- examines the implications of the increase in debt over the last decade;
- analyzes potential issues associated with being at the debt limit; and
- recommends changes in State debt management to reflect being at the debt limit.

### **State Has Expanded Authorizations Since 2000**

Since the 2000 legislative session, State debt has been increased by authorizing additional GO and transportation debt and authorizing new kinds of State debt. **Appendix 4** shows that the State has expanded debt authorizations in 17 separate actions: 11 actions increase GO bond authorizations; 3 actions increase transportation bond authorizations; GARVEEs are authorized; Program Open Space bonds are authorized; and bay restoration bonds are authorized.

These new and expanded authorizations increased the ratio of debt outstanding to personal income. **Exhibit 5** shows that debt outstanding increased from \$4.7 billion in fiscal 1999 to \$9.4 billion in fiscal 2010.

**Exhibit 5**  
**Increase in State Debt**  
**Fiscal 1999-2010**  
**(\$ in Billions)**

	<u>1999</u>	<u>2010</u>	<u>Annual</u> <u>% Change</u>
Debt Outstanding	\$4.7	\$9.4	6.5%
GO Bonds Authorized	4.5	8.9	6.4%
GO Bonds Issued	3.5	6.5	5.8%
GO Bonds Unissued	1.0	2.4	8.3%

GO: general obligation

Source: Capital Debt Affordability Committee

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The issue now examines the consequences of the additional authorizations, which include:

- distribution of spending among capital projects;
- ability to provide operating budget relief by moving capital programs out of the operating budget and into the capital budget;
- additional debt service costs, even after program growth is slowed; and
- reaching the debt affordability limit.

**Distribution of Bonds Among Capital Projects**

Increasing GO bond authorizations has more than doubled capital budget spending. **Exhibit 6** provides a snapshot showing authorizations by program for the 2000 legislative session, before the increase in debt began, and 2010 legislative sessions, at the capital program's peak. Much of the new spending now supports public school and higher education projects. Authorizations in 2010 also support such areas as the environment, natural resources, housing, and transportation. Much of this is attributable to moving operating spending into the capital budget, which is discussed in the following section.

**Exhibit 6**  
**General Obligation Bond Capital Program Comparison**  
**2000 and 2010 Legislative Session Authorizations**  
(\$ in Millions)

<b><u>Function</u></b>	<b><u>2000</u></b> <b><u>Session</u></b>	<b><u>2010</u></b> <b><u>Session</u></b>
<b>State Facilities</b>		
Facilities Renewal	\$12.6	\$10.4
State Facilities Other	35.4	15.8
<b>Health/Social</b>		
Health Other	16.5	20.9
Health State Facilities	3.3	5.8
Private Hospitals	15.7	17.0
<b>Environment</b>		
Agriculture	0.0	29.8
Energy	0.0	0.0
Environment	20.8	172.3
Maryland Environmental Service	3.6	0.0
Natural Resources	16.4	118.2
<b>Public Safety</b>		
Local Jails	11.7	5.5
State Corrections	23.3	17.8
State Police	4.1	2.5
<b>Education</b>		
Education Other	3.5	9.1
School Construction <sup>1</sup>	96.7	259.7
<b>Higher Education</b>		
Community Colleges	38.7	78.7
Morgan State University	14.1	30.5
Private Colleges/Universities	11.0	8.0
University System	85.4	207.8
Other	5.7	0.0
<b>Housing/Community Development</b>		
Housing	13.5	37.4
Housing Other	6.1	0.2
<b>Economic Development</b>		
Economic Development	0.0	4.3
<b>Local Projects</b>		
Local Administration Projects	10.9	25.8
Local Legislative Projects	22.9	17.6

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<b><u>Function</u></b>	<b><u>2000 Session</u></b>	<b><u>2010 Session</u></b>
<b>Transportation</b>		
Highways	0.0	89.3
<b>De-authorizations</b>		
De-authorizations	-2.0	-39.7
<b>Total</b>	<b>\$469.9</b>	<b>\$1,144.6</b>

<sup>1</sup> Includes Qualified Zone Academy Bond authorizations, which total \$9.9 million in 2000 and \$4.6 million in 2010.

Source: *Effect of Long-term Debt on the Financial Condition of the State*, November 2010

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### **Debt Expansion Supported Capital Projects Funded in the Operating Budget**

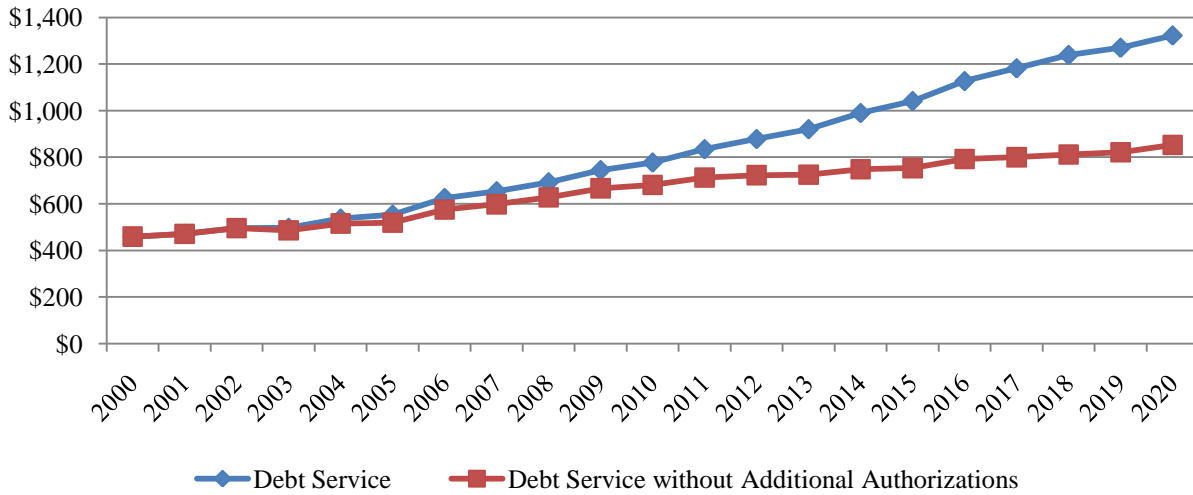
Adding debt does not just expand capital spending. A smaller, but also important, share of the additional debt supports capital projects previously funded in the operating budget. GO bond authorizations provided operating budget relief for the State as general fund revenues declined during the 2001 and 2007 through 2009 recessions. New authorizations supporting the operating budget include:

- Chapter 290 of 2002 authorizing an additional \$200 million in GO bonds. These funds supported PAYGO capital commitments for which operating budget funds were no longer available.
- Chapter 204 of 2003 authorized an additional \$200 million in GO bonds. These funds supported PAYGO capital commitments for which operating budget funds were no longer available.
- Chapter 203 of 2003 authorized the transfer of \$315 million from the Transportation Trust Fund to the general fund. In response, MDOT issued additional debt to maintain its capital program. The transfer corresponds with a sharp increase in transportation bonds outstanding.
- Chapter 485 of 2009 authorized an additional \$150 million to support PAYGO capital projects. The projects and programs funded include POS, the InterCounty Connector, Medevac helicopter replacement, and public safety communications systems.
- Chapter 483 of 2010 authorized an additional \$150 million to support PAYGO capital projects. The projects and programs funded include the Rural Legacy Program, Program Open Space, InterCounty Connector, Department of Housing and Community Development revolving loan programs, and Department of the Environment water quality and drinking water loan program.

**Debt Service Costs Increase in Response to New Authorizations**

These increased authorizations result in higher debt service costs. DLS estimates that fiscal 2012 debt service costs would have been \$723 million without the additional authorizations, as shown in **Exhibit 7**. This is \$156 million less than the current projection, which totals \$878 million. From fiscal 2010 to 2020, debt service costs are projected to increase by 5.5% annually. Without the increased authorizations, the growth rate for GO bond debt service costs would have been 2.5% annually. By fiscal 2020, increased authorizations add \$470 million to debt service costs with debt service costs exceeding \$1.3 billion.

**Exhibit 7**  
**Effect of Increased GO Bond Authorizations on Debt Service Costs**  
**Fiscal 2000-2020**  
**(\$ in Millions)**



GO: general obligation

Source: Department of Legislative Services, January 2011

The out-year debt service estimates are consistent with the CDAC’s new policy to reduce debt service costs. These new policies appear to have had some effect on debt service. For example, prior to the reduction in authorizations proposed in December 2009, the 10-year growth in debt service was projected to be 6.1%, which is 0.6% more than the current growth rate. Because of the nature of capital spending (primarily due to project funding that is authorized prior to planning and amortization schedules that do not retire principal in the first two years after bonds are issued), debt service will continue to increase at a high rate even after the State stops expanding capital spending.

## **State Debt Authorizations Are Reduced as the State Reaches the Affordability Limit**

Since it began expanding its capital program in 2000, the State has been through two recessions. The 2007 through 2009 recession was especially deep and resulted in lower out-year income and revenue estimates, which have reduced the State's debt capacity.

In December 2009, CDAC met to revise its recommended GO bond authorization. Since the committee had made its recommendation in September 2009, the Board of Revenue Estimates had substantially reduced the State's general fund revenue projections. The revised revenue projections were low enough to reduce the State debt service to revenues ratio to the point that it exceeded the CDAC's 8% limit. In response to these lower revenues, the committee reduced the out-year GO bond authorizations so that the debt service to revenues ratio is below the limit. The Administration's 2011 capital budget bill maintains GO bond authorizations at the level that was proposed in December 2009. These changes in authorizations confirm that, after 11 years of capital spending growth, the State is now facing a period of little or no capital spending growth.

## **Being at the Limit Poses Challenges**

This next section examines the implications of being at the affordability limit. The State still needs to confront old challenges, such as the amount requested for capital projects exceeding available funding. The State also is likely to confront new concerns, such as how to distribute reductions to total debt across different issuers, how to manage affordability factors outside State control, and how to manage the pressure to move projects outside affordability limits.

## **Proposed Projects Exceed Available Funding**

Just because the State is at the debt affordability limit, does not mean that all perceived needs have been met. As was the case before the State was at the limit, the State has a backlog of unfinished capital projects and unanticipated projects will be proposed. Examples from the major types of debt include:

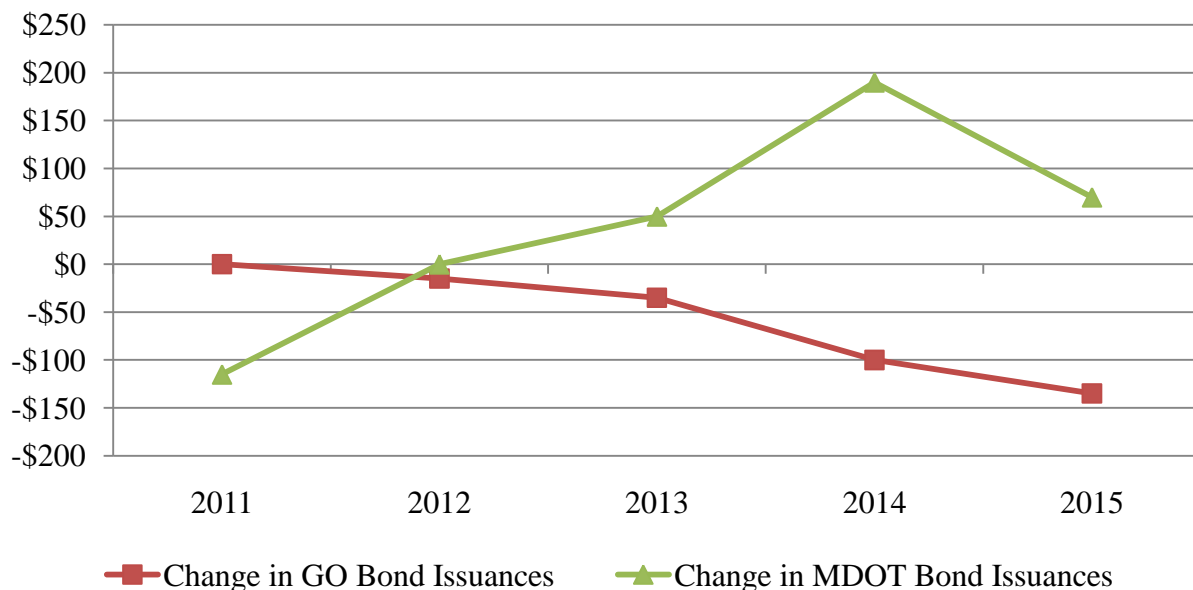
- GO bond project requests total \$8.4 billion from fiscal 2012 to 2016, while debt authorizations are limited to \$4.7 billion.
- Bay restoration bonds are projected to provide \$530 million to support improvements to wastewater treatment plants. Total project costs are \$537 million more than available from currently projected bonds and revenues. Fees may be raised to fill this gap. These fees could support bond issuances in excess of what is currently projected by CDAC.
- New leases, such as video lottery terminals, are procured periodically. Leases are more flexible than GO bonds and are often not anticipated in debt affordability projections. Also, the affordability projections do not include replacing the current leases when they expire after five years. Should new leases be necessary, current estimates understate debt.

### Distribution of State Debt Reductions

In December 2009, CDAC estimates projected that State debt service would exceed 8% of revenues by fiscal 2017. To keep debt within the affordability limits, the committee recommended reducing GO bond authorizations. The December 2009 recommendation did not address other types of State debt, such as transportation bonds.

As a consequence of reducing GO bond authorizations, GO bond issuances projected in September 2010 are projected to be less than issuances projected in October 2009. **Exhibit 8** shows that the decline in issuances begins in fiscal 2012, at about \$15 million, and increases through fiscal 2015, when \$135 million less is issued in GO bonds. Total issuances are \$285 million less than projected a year ago. Over the same period, the issuance of transportation bonds is projected to increase by \$195 million.

**Exhibit 8**  
**Change in Projected General Obligation and Transportation Bond Issuances**  
**September 2009 Compared to September 2010 CDAC Projections**  
**Fiscal 2011-2015**  
**(\$ in Millions)**



CDAC: Capital Debt Affordability Committee  
 GO: General Obligation  
 MDOT: Maryland Department of Transportation

Sources: *Report of the Capital Debt Affordability Committee on Recommended Debt Authorizations*, September 2009; Department of Budget and Management; and Maryland Department of Transportation

Since the State is now at the affordability limit, it is quite possible that the State will be required to reduce planned bond issuances again. In the first round of reductions, the GO program was the only program affected by required reductions.

### **Risk Concerns**

When CDAC reduced GO bond authorizations in December 2009, the committee was responding to a change in revenue forecasts. The State was forced to change capital spending plans in response to a change in conditions over which the State had no control. This is an example of the new risks the State will need to manage now that the State is at the debt affordability limit. Before the State was at the limit, changes in conditions did not result in revising authorizations; now that the State is at the limit, changes in conditions could result in revised authorizations. The State will need to monitor risks more closely and may, occasionally, need to reduce authorizations to keep within the affordability limits. In its 2010 report, CDAC identifies changes in personal income, revenues, interest rates, definitions of tax-supported debt, and issuance plans as components of risk. **The Treasurer's Office should brief the committees on the affordability risk analysis.**

### **Pressure to Move Projects Out of State Debt Funding**

One approach to maintaining capital spending within affordability limits is to redefine capital projects so that they no longer are classified as State debt. Recent examples of this include:

- **State Center:** On July 28, 2010, BPW approved the ground and occupancy lease for the phase I redevelopment of the State Center complex in Baltimore City. This was the first step following the board's approval of the Master Development Agreement between the State of Maryland and State Center LLC, which established the legal framework for a multi-year, multi-phase redevelopment of State Center leading ultimately to construction and rehabilitation of the site as a Transit-oriented Development to include commercial office space, market rate and low-income housing, retail space, and parking. While the housing and commercial office and retail space serve largely private purpose activities that do not qualify for tax-exempt financing, a key component of the total redevelopment includes up to 1,000,000 square feet (sq. ft.) of State office space which serves a public use that is supported by State taxes and, therefore, is traditionally financed within State debt affordability limits. To avoid classifying the project as State debt, the Administration has structured the phase I occupancy lease as an operating lease and intends to structure subsequent project phase leases similarly. In so doing, the Administration believes that such a lease structure removes the financing from the affordability limits. One advantage to this approach is that it avoids making further reductions to State debt programs at a time that the State is at capacity. However, DLS is concerned that this capacity was purchased at a premium. The project's average rent costs (which begin at \$37 per sq. ft.) are substantially higher than current market rates (\$22 per sq. ft.). Furthermore, this shifts the burden of paying for the infrastructure to the operating budget through the appropriation of annual rents at a time when the State faces a structural deficit.

- **Health Department Laboratory:** The Department of Health and Mental Hygiene (DHMH) has been authorized by the budget committees to allow the Maryland Economic Development Corporation (MEDCO) to finance the design and construction of a new public health laboratory at the Life Sciences and Technology Park in East Baltimore. The new facility will replace the existing 35-year-old central laboratory facility located at 201 West Preston Street in Baltimore. While a project such as this is usually included in the State's GO bond program due to the cost of the project, estimated at \$180 million, the Administration favored a financing mechanism that would allow the project to be completed outside of the State's debt limits. In 2009, DHMH presented a number of alternative financing proposals for this project, which included funding the project with GO bonds, capital leases, operating leases, and public-private partnership arrangements. Though DLS' and DHMH's analysis did not completely agree, there was a consensus that arrangements that include the project in the debt affordability limits (GO bonds and capital leases) were more cost effective for the State than arrangements that did not (operating leases and public-private partnerships). DBM advises that they will be pursuing a 20-year capital lease with annual payments ranging from \$11 million to \$14 million.

Now that the State debt is at the debt affordability limit, it is likely that there will be pressure to structure project financing so that projects are not included within State debt affordability limits. This can result in increased costs to the State.

## Recommendations

CDAC's recommended reduction in GO bond authorizations is a major change in the capital program. Over the past decade, the State has routinely increased capital authorizations. Now the State is limiting capital spending in the foreseeable future. When the State was below the debt affordability limit, authorizations for specific kinds of debt could be increased without affecting other kinds of debt. This is no longer the case. Since the State is at the limit, increasing debt for one program often means that another program is reduced. Also, if revenues underattain, capital program reductions may be necessary. The implication is that various capital programs will now be competing against one another.

CDAC calculates what level of debt is affordable and limits GO bond debt. The committee does not specifically limit other State debt. While this may have been adequate when there was additional debt capacity, it does not reflect the reality that State debt is at the limit. **In December 2010, the Spending Affordability Committee recommended that the budget committees consider and recommend a process that results in a comprehensive spending plan that annually proposes debt limits for all types of State debt that are encompassed within the debt affordability evaluation. Consistent with the committee's recommendation, DLS recommends the following:**

- **CDAC Should Recommend an Aggregate Debt Limit Encompassing All Types of State Debt:** The committee was created to manage State debt. Each summer, the committee meets and examines all State debt. The committee includes secretaries from the two largest capital programs (Department of Budget and Management (DBM) and MDOT) and is supported by

all agencies issuing debt. The committee reviews many issues and was created to provide a statewide perspective on debt. Since debt management begins with CDAC, reforming debt policies should also begin with CDAC.

- ***Administration Should Recommend a Specific Debt Limit for Each Type of State Debt:*** Section 8-113 of the State Finance and Procurement Article requires that by November 1 of each year, the Governor determines total new authorizations that the Governor considers advisable. This has been interpreted to be limited to GO bonds and does not include other types of State debt. The definition should be expanded to include other forms of State debt (MDOT bonds, GARVEEs, bay restoration bonds, stadium authority bonds, and capital leases). This would set debt targets that the Spending Affordability Committee could review each fall.
- ***Each Year, the Governor Should Include Limits to All Types of State Debt in the Capital Budget Bill:*** This legislation would give each kind of State debt a statutory limit. The Governor should also include the details about the State's six-year debt plan with the documentation that is submitted with the budget each year.
- ***The Legislature Should Review the Proposed Debt Limits:*** Submitting a bill that limits State debt also provides the legislature with an opportunity to review the various limits. The limits could be amended to reflect the legislature's priorities.
- ***A Process That Allows the Limits to Be Exceeded under Clearly Defined Circumstances Should Be Developed:*** Although planning is a critical component to a coherent and efficient budget process, all contingencies cannot be foreseen at all times. At times, there may be a compelling need for the State to increase debt issuances in a particular year. Creating a process to increase limits gives the State additional flexibility. However, this process should have specific limits. The limits should define under what conditions debt could be increased (for example, responding to a natural disaster upon a declaration of emergency by BPW) and should require that the Administration demonstrate the fiscal impact of additional debt.

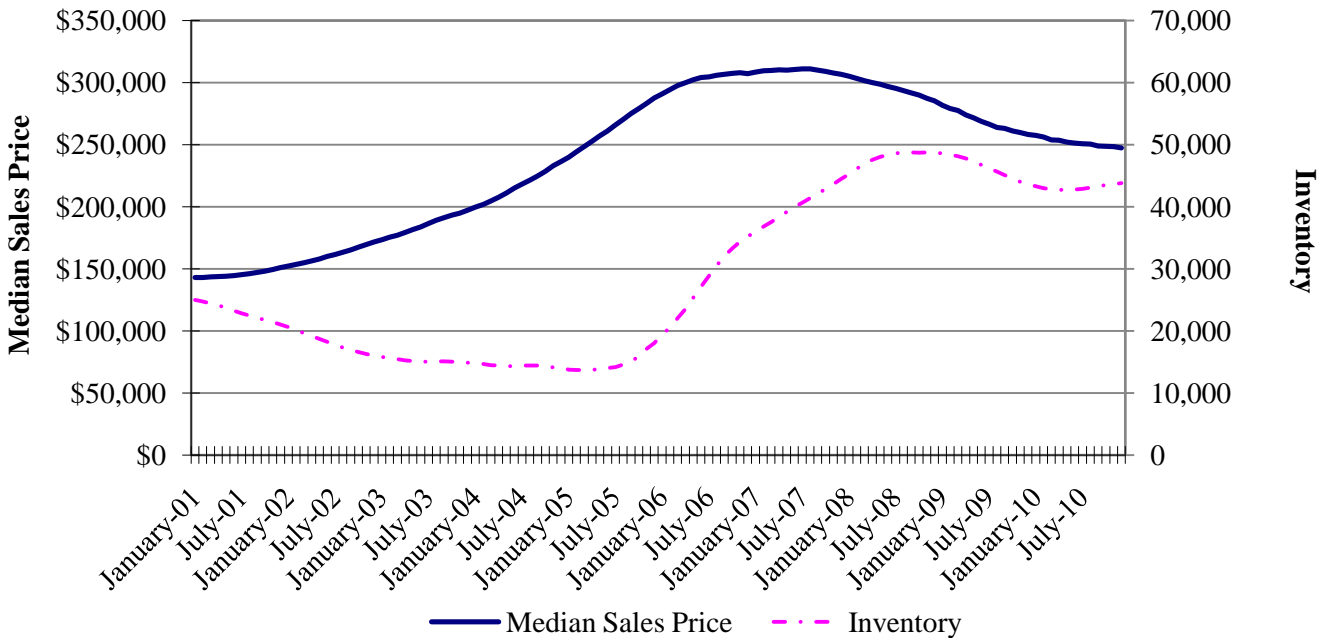
**DLS recommends that legislation enacting these changes be adopted during the 2011 legislative session.**

## **2. Revised State Property Tax Revenues Are Projected to Be Insufficient to Support Debt Service in the Out-years**

GO bond debt service costs are supported by the ABF. The fund's largest revenue sources include State property tax revenues and proceeds from bond sale premiums. Other revenue sources include interest and penalties on property taxes 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 April 2006, the State property tax rate was set at \$0.112 per \$100 of assessable base.

The major revenue source supporting debt service payments is the State property tax. State property tax collections are influenced by trends in the housing market. **Exhibit 9** shows that this decade has seen a substantial increase in real estate values followed by a decline in values. It also appears that inventories remain somewhat high, even though they have declined since peaking in 2008. In November 2010, the State Department of Assessments and Taxation (SDAT) released its assessable base estimates for fiscal 2011 to 2013. The recent declines in property values are expected to lead to declining State property tax receipts.

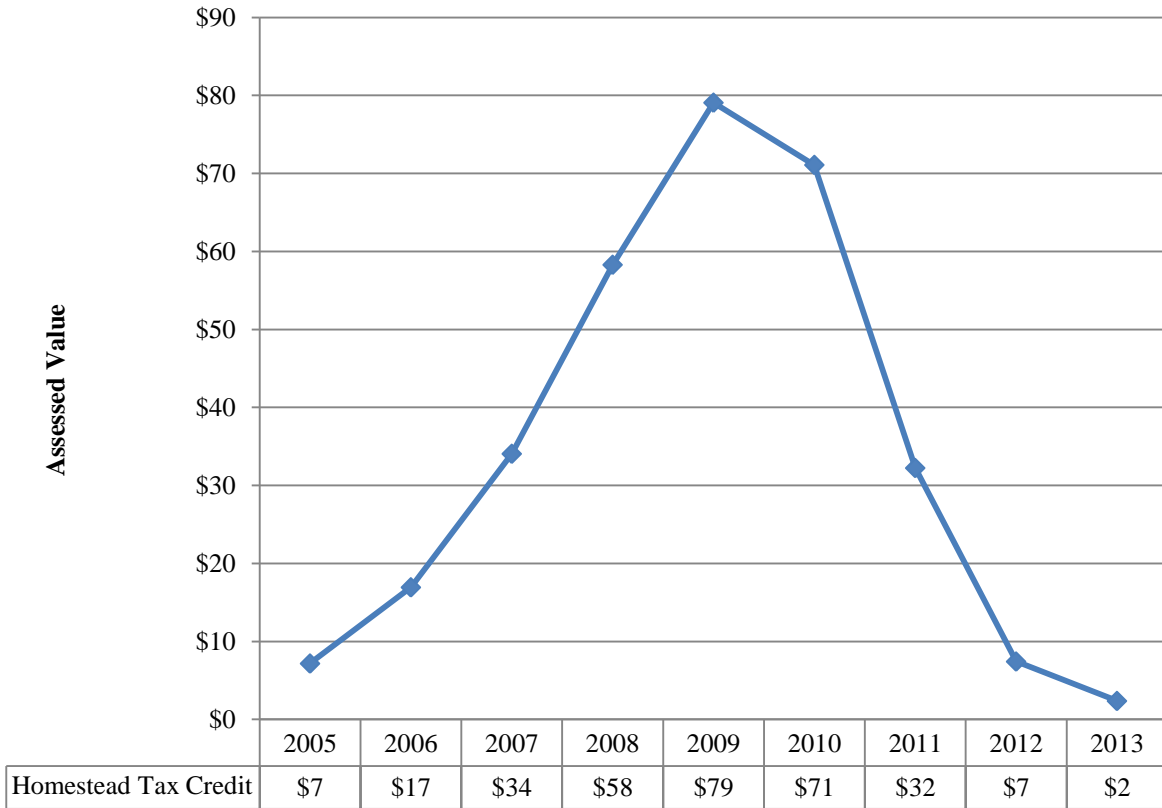
**Exhibit 9**  
**Maryland Housing – Median Prices and Inventory**  
**12-month Moving Average**  
**January 2001 to December 2010**



Source: Maryland Association of Realtors

Another concern about the recent SDAT estimates is the steep decline of the projected Homestead Tax Credit. This credit limits the increase in State property assessments subject to the property tax to 10%. If reassessing a resident’s property results in an increase that exceeds 10%, the homeowner receives a credit for any amount above 10%. This limits growth in revenues when property values rise quickly. It also builds a hedge should values decline. **Exhibit 10** shows that State credits increased to \$79 billion in fiscal 2009, in response to increases in assessments. As home values declined, the homestead credit declined and revenues continued to slowly increase. The result was to smooth State revenues; State property tax revenue growth was slower as home values increased and there was no decline in revenues when home values decreased. By fiscal 2013, the aggregate homestead credits are projected to be \$2 billion. In subsequent years, declining home values will no longer be hedged and revenues are likely to decline also.

**Exhibit 10**  
**State Property Tax Homestead Tax Credits**  
**Fiscal 2005-2013**  
**(\$ in Billions)**



Source: Department of Assessments and Taxation

**Exhibit 11** shows that lower estimated property value assessments are projected to result in reduced State property tax receipts. Over the forecast period, annual debt service costs are expected to increase by over 5%, resulting in a growing gap between property tax revenues and debt service expenditures. In fiscal 2011, State property taxes are only \$35 million less than debt service costs. By fiscal 2016, debt service costs are \$417 million higher than property tax revenues. Consequently, general fund appropriations, which are expected to begin in fiscal 2013, are projected to increase to \$398 million in fiscal 2016.

**Exhibit 11**  
**Estimated Annuity Bond Fund Activity**  
**With General Fund Subsidy to Fund Debt Service**  
**Fiscal 2011-2016**  
**(\$ in Millions)**

	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>	<u>2016</u>
<b>Special Fund Revenues</b>						
State Property Tax Receipts	\$800	\$762	\$738	\$712	\$712	\$712
Bond Sale Premiums	47	10	0	0	0	0
Other Revenues	2	2	2	2	2	2
ABF Fund Balance Transferred from Prior Year	105	130	37	1	0	0
<b>Subtotal Special Fund Revenues Available</b>	<b>\$954</b>	<b>\$903</b>	<b>\$778</b>	<b>\$714</b>	<b>\$714</b>	<b>\$715</b>
General Fund Appropriations	0	0	132	261	312	398
Transfer Tax Revenues <sup>1</sup>	1	2	2	6	6	6
Federal Fund Appropriations	9	11	11	11	11	11
<b>Total Revenues</b>	<b>\$965</b>	<b>\$916</b>	<b>\$922</b>	<b>\$992</b>	<b>\$1,044</b>	<b>\$1,130</b>
<b>Projected Debt Service Expenditures<sup>2</sup></b>	<b>\$835</b>	<b>\$878</b>	<b>\$922</b>	<b>\$992</b>	<b>\$1,044</b>	<b>\$1,129</b>
<b>ABF End-of-year Fund Balance</b>	<b>\$130</b>	<b>\$37</b>	<b>\$1</b>	<b>\$0</b>	<b>\$0</b>	<b>\$1</b>
<b>State Property Tax Rate Per \$100 of Assessable Base</b>	<b>\$0.112</b>	<b>\$0.112</b>	<b>\$0.112</b>	<b>\$0.112</b>	<b>\$0.112</b>	<b>\$0.112</b>

ABF: Annuity Bond Fund

<sup>1</sup> Supports \$70.0 million of general obligation bonds issued in 2010 to support Program Open Space.

<sup>2</sup> Department of Legislative Services assumes Qualified Zone Academy issuances totaling \$15.9 million in fiscal 2012 and \$15.3 million in fiscal 2013.

Source: Department of Legislative Services, January 2011

Another approach to manage this deficit is to increase State property tax rates. **Exhibit 12** shows that State property taxes would need to be increased to \$0.133 per \$100 of assessable base in fiscal 2013. This increases to \$0.175 per \$100 of assessable base in fiscal 2016.

**Exhibit 12**  
**Annuity Bond Fund Activity**  
**Increased State Property Taxes Fund Deficit**  
**Fiscal 2011-2016**  
**(\$ in Millions)**

	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>	<u>2016</u>
<b>Special Fund Revenues</b>						
State Property Tax Receipts	\$800	\$762	\$875	\$970	\$1,021	\$1,110
Bond Sale Premiums	47	10	0	0	0	0
Other Revenues	2	2	2	2	2	2
ABF Fund Balance Transferred from Prior Year	105	130	37	6	4	1
<b>Subtotal Special Fund Revenues Available</b>	<b>\$954</b>	<b>\$903</b>	<b>\$915</b>	<b>\$978</b>	<b>\$1,027</b>	<b>\$1,113</b>
General Fund Appropriations	0	0	0	0	0	0
Transfer Tax Revenues <sup>1</sup>	1	2	2	6	6	6
Federal Fund Appropriations	9	11	11	11	11	11
<b>Total Revenues</b>	<b>\$965</b>	<b>\$916</b>	<b>\$928</b>	<b>\$996</b>	<b>\$1,045</b>	<b>\$1,131</b>
<b>Projected Debt Service Expenditures<sup>2</sup></b>	<b>\$835</b>	<b>\$878</b>	<b>\$922</b>	<b>\$992</b>	<b>\$1,044</b>	<b>\$1,129</b>
<b>ABF End-of-year Fund Balance</b>	<b>\$130</b>	<b>\$37</b>	<b>\$6</b>	<b>\$4</b>	<b>\$1</b>	<b>\$2</b>
<b>State Property Tax Rate per \$100 of Assessable Base</b>	<b>\$0.112</b>	<b>\$0.112</b>	<b>\$0.133</b>	<b>\$0.153</b>	<b>\$0.161</b>	<b>\$0.175</b>

ABF: Annuity Bond Fund

<sup>1</sup> Supports \$70.0 million of general obligation bonds issued in 2010 to support Program Open Space.

<sup>2</sup> Department of Legislative Services assumes Qualified Zone Academy issuances totaling \$15.9 million in fiscal 2012 and \$15.3 million in fiscal 2013.

Source: Department of Legislative Services, January 2011

ABF revenues are insufficient to support debt service past fiscal 2012. Increased debt service costs combined with reduced State property values expands the gap between revenues and expenditures. **The State Treasurer's Office should brief the committees on the out-year ABF forecast. This should include a discussion of how bond rating agencies perceive the State's long-term fiscal condition.**

### **3. Will the State Be Issuing Taxable Bonds Soon?**

The State's capital program supports a number of different public policy objectives such as health, environmental, public safety, education, housing, and economic development objectives. Federal government regulations allow the State to issue debt that does not require the buyer to pay federal taxes on interest earnings. In cases where investors do not pay federal income taxes, they are willing to settle for lower returns. Investors in taxable debt require higher returns to offset their tax liabilities. Consequently, the State can offer lower interest rates on tax-exempt bonds.

Federal laws and regulations limit the kinds of activities the proceeds from tax-exempt bonds can support. One such requirement limits private activities or private purposes of the bond proceeds to 5% of the bond sales proceeds. Another requirement limits the bonds to \$15 million for business use projects and \$5 million for business loans. Examples of programs that support private activities or uses include the Partnership Rental Housing and Neighborhood Business Development programs of the Department of Housing and Community Development, Hazardous Substance Cleanup Program of the Department of the Environment, Public Safety Communications program of the Department of Information Technology, and the Physical Sciences Complex at the University of Maryland, College Park.

To avoid exceeding the private activity limits imposed in the federal regulations, the State has previously appropriated funds in the operating budget instead of issuing debt for private purpose programs and projects. Recent years' fiscal constraints have limited the amount of operating funds available for capital projects. To continue these programs, the State authorized GO bonds. In fiscal 2011, the State began migrating private purpose programs from the operating budget into the capital budget.

#### **Bond Sale Data Shows That Taxable Bonds Are More Expensive**

This is not the first time that the State has funded private purpose projects with GO bonds. After the 2001 recession, the State also moved capital projects from the operating budget to the capital budget. In 2005, the State reached its limit with respect to private activity exemptions in tax-exempt issuances, and the State was forced to sell taxable debt. These sales provide data from actual bond sales that can be used to test the hypothesis that taxable debt is more expensive than tax-exempt debt.

The State has had three taxable bond sales. After the sales, DLS prepared an analysis of the costs of the taxable bond sales and compared those costs with tax-exempt bond sales. **Exhibit 13** shows that \$65.0 million in taxable bond sales increased debt service costs by an estimated \$2.8 million.

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**Exhibit 13**  
**Cost of Taxable Debt Issuances**  
**(\$ in Millions)**

<u>Date of Issuance</u>	<u>Years to Maturity</u>	<u>Amount Issued</u>	<u>Total Debt Service</u>	<u>Additional Cost</u>
March 2, 2005	3	\$25.0	\$26.9	\$0.5
July 20, 2005	7	20.0	24.5	1.1
March 1, 2006	7	20.0	25.0	1.2
<b>Total</b>		<b>\$65.0</b>	<b>\$76.4</b>	<b>\$2.8</b>

Source: Department of Legislative Services, January 2011

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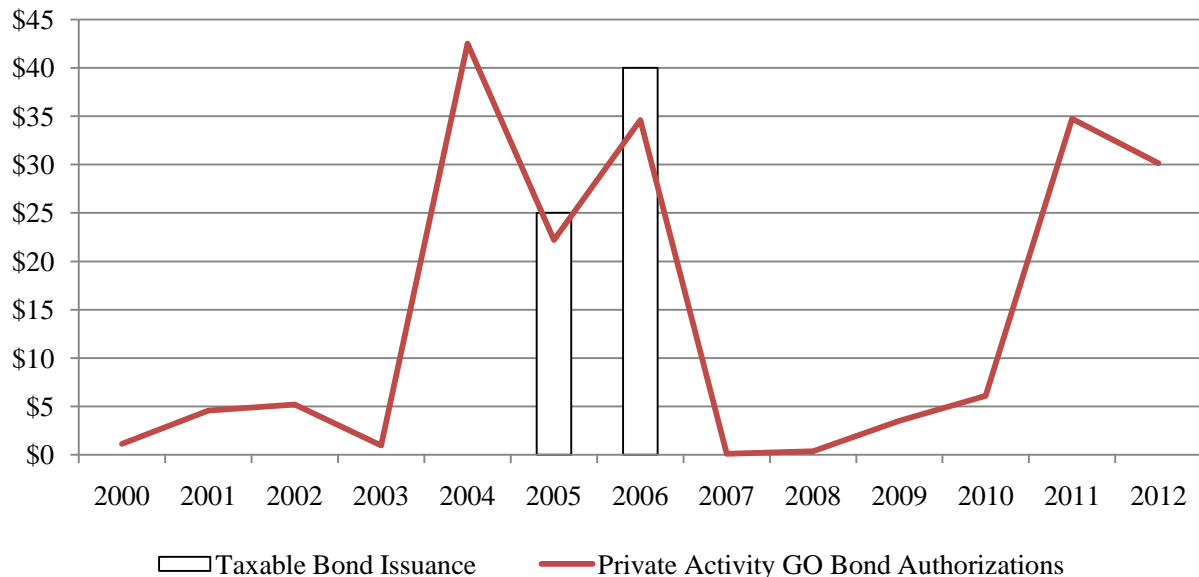
**Recent Increase in Private Purpose Authorizations Is Similar to Actions Taken Prior to 2005 Taxable Bond Issuances**

Because of the nature of capital projects, a number of capital projects contain some private purpose components. For example, a State building could have a cafeteria that is operated by a private vendor. In that case, there is private activity in the building, but it is only a small share of the buildings operations. To allow some flexibility in public buildings financed with tax-exempt debt, federal regulations provide room for some small portion of private activity. However, this limit is small and cannot indefinitely support large private purpose projects.

Each year, when DBM puts together its capital budget, it acknowledges that there are projects that have a private activity component. **Exhibit 14** shows that in most years, private purpose projects are \$5 million or less. In fiscal 2004, private purpose projects increased to approximately \$43 million and remained at a high level through fiscal 2006. As a result of this high level of private purpose projects, the State issued \$65 million in taxable bonds in fiscal 2005 and 2006.

The fiscal 2011 GO bond program again authorized a substantial amount of private purpose debt; approximately \$35 million is authorized. Considering the strict limits that federal regulations place on private activity projects in tax-exempt debt, it appears as though there is a good chance that the State will need to issue taxable bonds again soon. **The State Treasurer’s Office should brief the committees on the level of proposed GO bond authorizations that are subject to private purpose restrictions. This should include a discussion of the likelihood, timing, and amount of any taxable debt issuance.**

**Exhibit 14**  
**Private Activity Authorizations and Taxable Bond Issuances**  
**Fiscal 2000-2012**  
**(\$ in Millions)**



GO: general obligation

Source: Department of Budget and Management’s *Capital Improvement Plans*, Fiscal 2000 to 2012; *Joint Chairmen’s Report*, 2010

**4. Update on American Recovery and Reinvestment Bonds**

In February 2009, President Barack H. Obama signed the ARRA into law. In addition to authorizing federal spending and reducing federal taxes, the bill included provisions that affect State and municipal bonds. Specifically, the Act authorized the following debt: BABs; QSCBs; QZABs; Qualified Energy Conservation Bonds (QECBs); Clean Renewable Energy Bonds (CREBs); Recovery Zone Facilities Bonds (RZFBs); and Recovery Zone Economic Development Bonds (RZEDBs). Chapter 649 of 2009 confirmed BPW authority to issue these bonds.

**Qualified Energy Conservation Bonds**

QECBs were created by the Tax Extenders and Alternative Minimum Tax Relief Act of 2008. The ARRA increased the allocation. The bonds are tax credit bonds, and the proceeds can only be used for conservation projects. Maryland’s allocation is \$58.4 million, of which \$51.9 million is for

local governments, and the remaining \$6.5 million is for the State. The State Treasurer's Office is not aware of any QECB issuances, so marketability may be an issue.

The State Treasurer's Office has considered using these authorizations to support Energy Performance Contracts (EPCs) and public school construction projects. **The State Treasurer's Office should brief the committees on the use of QECBs. This should include a discussion of the marketability of QECBs.**

### **Clean Renewable Energy Bonds**

CREBS are an existing tax credit bond program that finances renewable energy facilities. ARRA changed the program so that there is a 70% tax credit and the issuer is responsible for 30% of interest costs. The kinds of projects that qualify include electricity generation from wind and hydropower. The bonds can be issued by public power providers, cooperative electrical companies, certain nonprofit electrical utilities, and governmental bodies. No more than one-third of the allocation may support projects owned by public power providers, cooperative electrical companies, and governments. To issue CREBS, an agency must first apply with the U.S. Treasury Department. Maryland has not applied for CREBS.

### **Build America Bonds**

This program, which was created by ARRA, allows State and local governments to issue taxable bonds in 2009 and 2010. The bonds support projects that qualify for tax-exempt bonds. The bonds are offered with a tax credit or a direct payment option. Under the tax credit option, the taxpayer holding the bond is eligible to receive a tax credit equal to 35% of the interest paid. Under the direct payment option, the issuer receives federal funds equal to 35% of the interest cost. The State has chosen the direct payment option. The federal government did not set a limit on the amount of BABs that can be issued. As discussed in the performance analysis, BPW issued \$583.2 million between August 2009 and July 2010, and DLS estimates that this reduced total debt service costs \$38.8 million. BABs expired on December 31, 2010. They have not been reauthorized by the federal government.

### **Recovery Zone Economic Development Bonds**

RZEDBs are similar to BABs. RZEDBs offer a larger credit, 45% instead of 35%, than the BABs. RZDEBs must support economic development purposes, such as projects located in economic development recovery zones or projects supporting job training or educational programs. A Recovery Zone is defined as an area having significant poverty, unemployment, home foreclosures or general distress, or an area that has already been federally designated as an Empowerment Zone or Renewal Community. In addition to the federally designated areas, the county or municipality may designate areas within their jurisdiction as Recovery Zones. The counties and Baltimore City received Maryland's entire \$208.9 million allocation. If a locality waives its allocation, a State agency could issue the bonds or give the allocation to another locality.

Executive Order 01.01.2009.14 designated the Department of Business and Economic Development (DBED) as the entity responsible for tracking the use of RZEDB allocations and facilitating the transfer of any unused allocations. DBED advises that it is not aware of any issuances of RZDEBs by Maryland State or local agencies. Authorization to issue these bonds has expired.

### **Recovery Zone Facilities Bonds**

RZFBs are tax-exempt bonds which support private activity projects that otherwise do not qualify as tax-exempt. At least 95% of the proceeds must support projects in a recovery zone. The counties and Baltimore City received Maryland's entire \$313.3 million allocation. If a locality waives its allocation, the State could issue the bonds or give the allocation to another locality.

Executive Order 01.01.2009.14 designated DBED as the entity responsible for tracking the use of RZFB allocations and facilitating the transfer of any unused allocations. DBED advises that the State has issued \$129.2 million supporting projects in Baltimore City and Washington County. The State was a conduit issuer and does not have any obligation to repay these bonds. Another \$41.9 million was issued by local governments. These issuances supported projects in Baltimore, Harford, and Howard counties. \$142.2 million was unissued.

### **Qualified Zone Academy Bonds**

QZABs were created under the federal Tax Reform Act of 1997 as a new type of debt instrument to finance education projects. Through fiscal 2009, Maryland allowed QZAB proceeds to be used only for renovation and repair (brick-and-mortar) projects as part of the Aging Schools Program. Chapter 707 of 2009 expanded the use of previously authorized QZABs for equipment, which is an authorized use under Section 1397E of the Internal Revenue Service code. Federal law requires that QZAB projects also receive a 10% private sector match, which could include cash or in-kind goods and services.

The bonds are tax-credit bonds; the buyers receive a federal tax credit. The State pledges its full faith and credit when issuing QZABs, and the bonds are considered State debt. Through December 2010, the State issued \$52.2 million in QZABs. The ARRA authorized another \$15.9 million in QZABs in 2009 and 2010, the last of which must be issued before the end of calendar 2012.

QZABs are attractive to the State because they are less expensive than issuing GO debt. QZABs debt service costs are annual sinking fund payments for the principal. With some of the earlier QZAB issuances, the sinking fund earned interest that could be applied to the principal. Consequently, the cost of these QZABs was less than the amount borrowed. For example, **Exhibit 15** shows that the first QZAB issuance in 2001 generated \$18.1 million in principal for the State, with payments totaling \$13.3 million. DLS estimates that \$18.1 million in GO bonds would have required \$26.9 million in debt service costs. In this case, QZABs reduced debt service costs by \$14.4 million.

**Exhibit 15**  
**Maryland Qualified Zone Academy Bond Issuances**  
(\$ in Thousands)

<u>Authorizing Legislation</u>	<u>Date Issued</u>	<u>Amount Authorized</u>	<u>Amount Issued</u>	<u>Total Payments</u>
Chapter 322 of 2000 <sup>1</sup> and Chapter 139 of 2001 <sup>1</sup>	Nov. 2001 <sup>1</sup>	\$18,098	\$18,098	\$13,320
Chapter 55 of 2003	Nov. 2004	9,043	9,043	7,356
Chapter 431 of 2005 <sup>2</sup>	Nov. 2006 <sup>2</sup>	9,364	4,378	3,609
Chapter 431 of 2005 <sup>2</sup>	Nov. 2007 <sup>2</sup>	n/a <sup>2</sup>	4,986	4,089
Chapter 585 of 2007	Dec. 2008	11,126	5,563	6,142
Chapter 585 of 2007	Nov. 2009 <sup>2</sup>	n/a <sup>2</sup>	5,563	6,275
Chapter 523 of 2010	Dec. 2010	4,543	4,543	4,543
<b>Total</b>		<b>\$52,174</b>	<b>\$52,174</b>	<b>\$45,333</b>

<sup>1</sup> November 2001 issuance includes authorizations made in 2000 and 2001.

<sup>2</sup> Qualified Zone Academy Bonds authorized in Chapter 431 of 2005 and 585 of 2007 are issued in two bond sales.

Note: Subtotals and totals may not sum due to rounding.

Source: State Treasurer's Office

In November 2009, the State issued \$5.6 million in QZABs. The bonds included a 1.6% supplemental coupon, requiring \$0.7 million in interest payments over the life of the QZABs. This compares favorably to GO bonds, which require \$2.7 million in interest payments for \$5.6 million issued at 5.0%.

The December 2010 issuance was sold as taxable debt with a direct federal payment to the State, similar to the BABs. In this case, the federal government will support 100% of the interest, which totals \$0.2 million per year. The State has two unissued allocations of QZAB: \$15.9 million that must be issued before the end of calendar 2011 and \$15.3 million that must be issued before the end of calendar 2012. The Treasurer's Office anticipates that the two ARRA QZAB issuances will also be issued as direct payment bonds.

## **Qualified School Construction Bonds**

QSCBs were created under ARRA as a new type of debt instrument to finance the construction, rehabilitation, or repair of public school facilities. The bonds are issued with the full faith and credit of the State and are debt. For purposes of calculating State debt affordability, QSCBs are included in the State's GO bond debt outstanding and debt service. These bonds were issued in the place of tax-exempt bonds. The net effect of the bonds was to reduce State debt service payments.

QSCBs are tax credit bonds entitling the holder of the bond to a tax credit for federal income purposes in lieu of receiving current interest on the bonds, similar to QZABs. The tax credit rate on QSCBs is set by the U.S. Treasury to allow for issuance of QSCBs at par and with no interest costs to the issuer. Unlike QZABs, tax credits may be stripped from bonds and sold separately, which could increase the marketability of the bonds, and do not require a 10% private match. These bonds can be issued to support the public school construction program in place of GO bonds. The State was authorized to issue up to \$50.3 million in QSCBs in 2009 and another \$45.2 million in 2010.

Under ideal circumstances, the bonds sell at par without any interest payments (referred to as a supplemental coupon). Prior to December 2009, QSCB were sold with supplemental coupon payments (such as the Baltimore County sale which included a 1.25% coupon) or at a discount (such as the Virginia Public School sale which generated proceeds equal to 91% of the bonds' principal).

In December 2009, the State sold \$50.3 million in QSCBs at par without a supplemental coupon. The bonds retire in 2024 (fiscal 2025). The bonds generate savings by replacing previously authorized GO bond issuances that would have supported public school construction. Since there was no supplemental coupon, the State will not pay any interest on these bonds. This reduces debt service costs by an average of \$2.6 million annually, compared to GO bonds' debt service costs. To pay back the bonds, the State will make annual payments into a sinking fund.

The State's second sale was in July 2010, when it sold \$45.2 million in QSCBs. The bonds will be retired in 2025. The bonds generate savings by replacing previously authorized GO bond issuances that would have supported public school construction. Issuing \$45.2 million in QSCBs reduced debt service costs by an estimated \$21.9 million over 15 years, when compared to issuing GO bonds. To pay back the bonds, the State will make annual payments into a sinking fund.

## ***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)

	<b><u>General Fund</u></b>	<b><u>Special Fund</u></b>	<b><u>Federal Fund</u></b>	<b><u>Reimb. Fund</u></b>	<b><u>Total</u></b>
<b>Fiscal 2010</b>					
Legislative Appropriation	\$0	\$784,987	\$0	\$0	\$784,987
Deficiency Appropriation	0	0	857	0	857
Budget Amendments	0	0	0	0	0
Cost Containment	0	0	0	0	0
Reversions and Cancellations	0	-8,321	0	0	-8,321
<b>Actual Expenditures</b>	<b>\$0</b>	<b>\$776,666</b>	<b>\$857</b>	<b>\$0</b>	<b>\$777,523</b>
<b>Fiscal 2011</b>					
Legislative Appropriation	\$0	\$834,344	\$7,640	\$0	\$841,984
Budget Amendments	0	0	0	0	0
<b>Working Appropriation</b>	<b>\$0</b>	<b>\$834,344</b>	<b>\$7,640</b>	<b>\$0</b>	<b>\$841,984</b>

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

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## **Fiscal 2010**

Generally, the State has two bond sales each year. In fiscal 2010, BPW sold bonds four times. Actual spending was \$776.7 million, which was \$8.3 million less than anticipated in the legislative appropriation. Major changes include:

- the March 2009 bond sale's fiscal 2010 debt service costs were \$4.3 million less than anticipated;
- the August 2009 bond sale's fiscal 2019 debt service costs were \$2.6 million less than anticipated;
- the QSCB issuance in October 2009 added \$4.4 million in unanticipated debt service costs;
- the December 2009 refunding reduced debt service costs by \$4.6 million; and
- the February 2010 refunding reduced debt service costs by \$0.8 million.

**Fiscal Summary  
Public Debt**

<u>Program/Unit</u>	<u>FY 10 Actual</u>	<u>FY 11 Wrk Approp</u>	<u>FY 12 Allowance</u>	<u>Change</u>	<u>FY 11 - FY 12 % Change</u>
01 Redemption and Interest on State Bonds	\$ 777,522,955	\$ 835,183,644	\$ 878,410,403	\$ 43,226,759	5.2%
01 Program Open Space Bond Payments	0	6,800,000	0	-6,800,000	-100.0%
<b>Total Expenditures</b>	<b>\$ 777,522,955</b>	<b>\$ 841,983,644</b>	<b>\$ 878,410,403</b>	<b>\$ 36,426,759</b>	<b>4.3%</b>
Special Fund	\$ 776,665,877	\$ 834,344,026	\$ 867,349,936	\$ 33,005,910	4.0%
Federal Fund	857,078	7,639,618	11,060,467	3,420,849	44.8%
<b>Total Appropriations</b>	<b>\$ 777,522,955</b>	<b>\$ 841,983,644</b>	<b>\$ 878,410,403</b>	<b>\$ 36,426,759</b>	<b>4.3%</b>

Note: The fiscal 2011 appropriation does not include deficiencies. The fiscal 2012 allowance does not include contingent reductions.

**Maryland’s General Obligation Bonds’ True Interest Cost Analysis**  
**Statistically Significant Independent Variables**

<u>Sale Date</u>	<u>TIC</u>	<u>Delphis Rate</u>	<u>MD/US PI</u>	<u>Years to Maturity</u>	<u>Amount Sold</u>	<u>Taxable</u>	<u>BABs</u>
March 13, 1991	6.31	6.15	2.261	10	\$95,000,000	No	No
July 10, 1991	6.37	6.50	2.240	10	100,000,000	No	No
October 9, 1991	5.80	5.70	2.230	10	120,000,000	No	No
May 13, 1992	5.80	5.75	2.220	10	120,000,000	No	No
January 13, 1993	5.38	5.40	2.221	10	130,000,000	No	No
May 19, 1993	5.10	5.10	2.212	10	130,000,000	No	No
October 6, 1993	4.45	4.45	2.206	10	140,000,000	No	No
February 16, 1994	4.48	4.50	2.208	10	120,000,000	No	No
May 18, 1994	5.36	5.35	2.199	10	120,000,000	No	No
October 5, 1994	5.69	5.50	2.191	10	160,000,000	No	No
March 8, 1995	5.51	5.35	2.184	10	175,000,000	No	No
October 11, 1995	4.95	4.80	2.163	10	150,000,000	No	No
February 14, 1996	4.51	4.35	2.159	10	170,000,000	No	No
June 5, 1996	5.30	5.10	2.144	10	150,000,000	No	No
October 9, 1996	4.97	4.90	2.144	10	170,000,000	No	No
February 26, 1997	4.90	4.70	2.136	10	240,000,000	No	No
July 30, 1997	4.64	4.50	2.135	10	250,000,000	No	No
February 18, 1998	4.43	4.25	2.119	10	250,000,000	No	No
July 8, 1998	4.57	4.40	2.128	10	250,000,000	No	No
February 24, 1999	4.26	4.10	2.134	10	225,000,000	No	No
July 14, 1999	4.83	4.80	2.146	10	125,000,000	No	No
July 19, 2000	5.05	4.85	2.157	10	200,000,000	No	No
February 21, 2001	4.37	4.28	2.178	10	200,000,000	No	No
July 11, 2001	4.41	4.39	2.201	10	200,000,000	No	No
March 6, 2002	4.23	4.17	2.233	10	200,000,000	No	No
July 31, 2002	3.86	3.89	2.241	10	225,000,000	No	No
February 19, 2003	3.69	3.77	2.235	10	500,000,000	No	No
July 16, 2003	3.71	3.56	2.250	10	500,000,000	No	No
July 21, 2004	3.89	3.89	2.254	10	400,000,000	No	No
March 2, 2005	3.81	3.72	2.259	10	350,000,000	No	No
July 20, 2005	3.79	3.63	2.268	10	430,000,000	No	No
March 1, 2006	3.87	3.89	2.242	10	280,000,000	No	No
July 26, 2006	4.18	4.09	2.238	10	350,000,000	No	No
February 28, 2007	3.86	3.77	2.228	10	325,000,000	No	No
August 1, 2007	4.15	4.02	2.218	10	375,000,000	No	No
March 2, 2005	3.87	3.68	2.259	2	25,000,000	Yes	No
July 20, 2005	4.43	3.65	2.268	5	20,000,000	Yes	No
March 1, 2006	4.98	3.92	2.242	5	20,000,000	Yes	No
February 27, 2008	4.14	3.90	2.208	10	400,000,000	No	No
July 16, 2008	3.86	3.76	2.213	10	415,000,000	No	No

*X00A00 – Public Debt*

Appendix 3 (Cont.)

<u>Sale Date</u>	<u>TIC</u>	<u>Delphis Rate</u>	<u>MD/US PI</u>	<u>Years to Maturity</u>	<u>Amount Sold</u>	<u>Taxable</u>	<u>BABs</u>
March 4, 2009	3.39	3.51	2.287	9	199,220,000	No	No
March 2, 2009	3.63	3.47	2.287	10	225,780,000	No	No
August 5, 2009	2.93	3.17	2.303	9	200,000,000	No	No
August 3, 2009	3.20	3.16	2.303	9	235,000,000	No	No
August 5, 2009	3.02	3.17	2.303	15	50,000,000	No	Yes
October 21, 2009	2.93	3.19	2.242	8	141,800,000	No	No
October 21, 2009	3.06	3.19	2.242	14	51,800,000	No	Yes
February 24, 2010	2.85	3.18	2.262	12	400,000,000	No	Yes
July 28, 2010	1.64	3.46	2.259	5	143,335,000	No	No
July 28, 2010	1.91	3.46	2.259	6	221,665,000	No	No
July 28, 2010	2.74	3.46	2.259	14	75,000,000	No	Yes

BABs: Build America Bonds

TIC: True Interest Cost

Source for Delphis Rate: Maryland State Treasurer's Office, The Bond Buyer

Source for Personal Income (PI): Federal Bureau of Economic Analysis

Remaining Sources: Bond Sale Official Statements

### New and Increased Debt Authorizations Since 2000

<u>Initial Authorization</u>	<u>Type of Debt Authorized</u>	<u>Amount Authorized</u>	<u>Supporting Revenues</u>	<u>Effect on Capital Spending</u>
Chapter 111 of 2001	GO Bonds	\$30.0 million annually	State property taxes and general fund	Increase the State capital program
Chapter 440 of 2002	Consolidated Transportation Bonds	Increased debt limit from \$1.2 billion to \$1.5 billion	Transportation Trust Fund revenues	Increase State transportation capital program
Chapter 103 of 2001	GO Bonds	\$5.0 million annually	State property taxes and general fund	Fund Tobacco Transition Program
Chapter 290 of 2002	GO Bonds	\$200 million in fiscal 2003	State property taxes and general fund	Move PAYGO capital projects into GO bond program
Chapter 204 of 2003	GO Bonds	\$200 million in fiscal 2004	State property taxes and general fund	Move PAYGO capital projects into GO bond program
Chapter 432 of 2004	GO Bonds	\$100 million annually for five years	State property taxes and general fund	Increase the State capital program
Chapter 9 of 2004	Consolidated Transportation Bonds	Increased debt limit from \$1.5 billion to \$2.0 billion	Transportation Trust Fund revenues	Increase State transportation capital program
Chapter 428 of 2004	Bay Restoration Bonds	Estimated \$530 million in total issuances	Bay restoration fee	Fund wastewater treatment plant improvements
Chapter 472 of 2005	GARVEEs	Not to exceed \$750 million	Federal transportation funds	Fund InterCounty Connector

*X00A00 – Public Debt*

Appendix 4 (Cont.)

<u>Initial Authorization</u>	<u>Type of Debt Authorized</u>	<u>Amount Authorized</u>	<u>Supporting Revenues</u>	<u>Effect on Capital Spending</u>
Chapter 46 of 2006	GO Bonds	Increase escalation to 3%, \$100 million annually in fiscal 2010	State property taxes and general fund	Increase the State capital program
Chapter 488 of 2007	GO Bonds	\$100 million annually	State property taxes and general fund	Increase the State capital program
Chapter 6, First Special Session of 2007	Consolidated Transportation Bonds	Increased debt limit from \$2.0 billion to \$2.6 billion	Transportation Trust Fund revenues	Increase State transportation capital program
Chapter 336 of 2008	GO Bonds	\$100 million annually	State property taxes and general fund	Increase the State capital program
Chapter 485 of 2009	GO Bonds	\$150 million in fiscal 2010	State property taxes and general fund	Move PAYGO capital projects into GO bond program
Chapter 419 of 2009	POS Bonds	\$70.0 million in fiscal 2010	State share of transfer tax revenues	Maintain POS spending in fiscal 2010
Chapter 719 of 2009	GO Bonds	\$2.0 million	State property taxes and general fund reimbursed by Community Development Administration	Contingent authorization for local government infrastructure bonds
Chapter 483 of 2010	GO Bonds	\$150 million in fiscal 2011	State property taxes and general fund	Move PAYGO capital projects into GO bond program

CDAC: Capital Debt Affordability Committee  
 GARVEEs: Grant Anticipation Revenue Vehicles  
 GO: general obligation  
 PAYGO: pay-as-you-go  
 POS: Program Open Space

Source: *Effect of Long-term Debt on the Financial Condition of the State*, November 2010