

**X00A00  
Public Debt**

***Operating Budget Data***

(\$ in Thousands)

	<u>FY 09 Actual</u>	<u>FY 10 Working</u>	<u>FY 11 Allowance</u>	<u>FY 10-11 Change</u>	<u>% Change Prior Year</u>
Special Fund	\$744,799	\$784,987	\$840,227	\$55,240	7.0%
<b>Adjusted Special Fund</b>	<b>\$744,799</b>	<b>\$784,987</b>	<b>\$840,227</b>	<b>\$55,240</b>	<b>7.0%</b>
Federal Fund	0	0	1,738	1,738	
<b>Adjusted Federal Fund</b>	<b>\$0</b>	<b>\$0</b>	<b>\$1,738</b>	<b>\$1,738</b>	
<b>Adjusted Grand Total</b>	<b>\$744,799</b>	<b>\$784,987</b>	<b>\$841,965</b>	<b>\$56,978</b>	<b>7.3%</b>

Note: For purposes of illustration, the Department of Legislative Services has estimated the distribution of selected across-the-board budget. The actual allocations are to be developed by the Administration.

- The budget includes a \$0.9 million federal fund deficiency appropriation. The funds are from the federal fiscal stimulus. Approval is recommended.
- 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 2011.

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

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## *Analysis in Brief*

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### **Issues**

***Cost of Debt Is Expected to Exceed Revenues Dedicated to Pay for the Debt:*** The State has been expanding debt authorizations since 2000. Economic conditions are such that the growth in revenues supporting debt service is expected to slow. The Administration proposes to use bond sale premiums to expand the capital program, which reduces funds available to support debt service in the out-years. **The Department of Legislative Services (DLS) recommends that the General Assembly delete the provision to expand the capital budget by authorizing bond sale premiums for capital projects. Absent this authorization, the premiums will reduce general fund appropriations to the Annuity Bond Fund.**

***State Debt Is Maxed Out, What Now?*** The fiscal 2011-2015 capital program has been reduced by \$400 million. The program was reduced because the State is at the affordability limit for debt service. The issue examines different policy options. **DLS recommends that the State maintain the current debt affordability limits. The State Treasurer’s Office should be prepared to brief the committees on the debt affordability process.**

***American Recovery and Reinvestment Act’s Debt Provisions:*** The federal fiscal stimulus includes provisions that expand current authorizations and create new authorizations. The various instruments are discussed. **The State Treasurer’s Office should be prepared to brief the committees on American Recovery and Reinvestment Act of 2009 bonds.**

### **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, Acts 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 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 47 bond sales (refunding sales are excluded): 40 competitively bid, tax-exempt; 3 competitively bid, taxable GO bond sales; 2 competitively bid, Build America Bonds (BABs); and 2 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 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. **Exhibit 1** shows which 6 independent variables are statistically significant factors (at the 5% confidence level) that influence the TIC:

**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>t-test</u>	<u>Tol.</u>	<u>Comment</u>
Delphis Scale	1.064	0.021	49.99	0.432	High beta suggests that the Delphis Scale has a strong relationship with the TIC.
MD PI/US PI	-1.522	0.284	-5.368	0.700	Negative coefficient suggests that as the Maryland economy strengthens, compared to the United States, the TIC declines.
Amount Sold	$6.49 \times 10^{-10}$	0.000	4.320	0.430	Every \$100 million sold adds 0.06% (6 basis points) to the TIC.
Taxable Debt	1.651	0.075	21.87	0.413	Taxable debt adds 1.65% (165 basis points) to TIC.
BABs	-0.915	0.070	-13.04	0.702	BABs yields are 0.92% (92 basis points) below tax-exempt yields.
Retail	0.245	0.067	3.639	0.762	Retail bonds are 0.25% (25 basis points) more expensive than traditional bonds.
Constant	2.989	0.652	4.568	n/a	

BABs: Build America Bonds

Ind.: Independent

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

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 2009

- ***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.

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- ***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.
- ***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 issuers 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.
- ***Retail Bonds:*** In 2009, the State issued retail bonds through a negotiated sale. The bonds were sold over a three-day period beginning five days before the sale to institutional investors. The sale gave Maryland citizens the first priority to buy GO bonds. The analysis estimates that retail bonds are more expensive than bonds sold competitively to institutional investors. However, these costs are offset somewhat by reducing the amount of bonds sold competitively to institutional investors.

### **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. Specific policies to evaluate include:

- ***Smaller Issuances Are Less Expensive Than Larger Issuances:*** Since 1991, Maryland has issued bonds 47 times. Bond sales vary from \$20 to \$500 million with an average size of \$210 million, a median size of \$200 million, and a standard deviation of approximately \$120 million. The DLS analysis estimates that increasing the size of a bond sale \$100 million increases the sale's TIC by 0.0649% (6 basis points). This increases annual debt service costs by just under \$6,500 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. However, if GO bond authorizations and issuances continue to increase, the Treasurer's Office may want to consider the costs and benefits associated with increasing the number of bond sales at smaller levels of issuance.

- ***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 1.65%, or 165 basis points, greater than tax-exempt debt with similar maturities. This premium adds \$3.6 million in debt service costs for the \$65.0 million issued.
- ***Build America Bonds Are Less Expensive Than Tax-exempt GO Bonds:*** The Treasurer's Office surmised that BABs with longer maturities would be less expensive than tax-exempt bonds with longer maturities. Consequently, the longer maturities in the August and October bond sales were issued as BABs. The DLS analysis confirms that savings were realized by issuing BABs; the equation estimates that the yield on the BABs (after adjusting for the federal subsidy) is 0.92% (92 basis points) less than the yield for 15-year tax-exempt bonds. This reduces the debt service costs almost \$1.0 million annually on the \$108.2 million that was issued.
- ***Retail Sales Are More Expensive Than Competitively Bid Sales to Institutional Investors:*** In 2009, Maryland issued its first two retail sales totaling \$225.8 million in March and \$235.0 million in August. Based on the regression analysis, DLS estimates that retail bonds' yield is approximately 0.25% (25 basis points) greater than the cost of competitively sold bonds to institutional investors. This is offset by savings attributable to reducing the total amount of bonds sold to institutional investors; issuing retail bonds reduces the TIC of bonds sold to institutional investors by 0.06% (6 basis points). DLS estimates that the net effect is that retail bonds were 0.10% (10 basis points) more expensive. Insofar as the bonds sold at a premium, the higher yield on the retail bonds did not result in higher debt service costs but instead resulted in a reduced bond sale premium. This analysis suggests that the two retail bond sales totaling \$460.8 million would have realized an additional \$3.5 million in bond sale premiums if the bonds had been sold to institutional investors through a competitive sale.

DLS' regression analysis uses statistical techniques to measure what factors influence the cost of GO bonds. The independent variables measured identify factors that are statistically significant with respect to bonds sold since 1991. The regression equation recognizes that there are factors that influence the cost that are not statistically significant. Examples include market liquidity or the yield

curve at the time of the sale. Factors that are not statistically significant should also be considered when developing bond policy. However, independent variables that have been demonstrated to be statistically significant should be given considerable weight when developing policies.

## **Fiscal 2010 Actions**

### **Proposed Deficiency**

The budget bill includes a federal fund deficiency totaling \$857,078. Though the funds could be appropriated by budget amendment, the Administration has chosen to include the appropriation in the budget bill. This is consistent with a request by the General Assembly to appropriate special and federal funds in the budget bill instead of the budget amendment process, whenever possible. The federal funds support BABs and represent 35% of the fiscal 2010 debt service's interest payment for the \$50 million in bonds sold in August 2009. BABs were authorized in the ARRA and are discussed in Issue 3, later in the analysis. **It is recommended that the General Assembly approve the federal funds.**

### **Federal Stimulus Fund**

The only ARRA appropriations in the budget bill support BABs. The Administration includes \$0.9 million in fiscal 2010 and another \$1.7 million in fiscal 2011. The federal funds represent 35% of the interest payment for BABs issued by the State. Public debt provisions of the stimulus are discussed in the Issue 3, later in the analysis.

## **Proposed Budget**

The fiscal 2011 allowance supports GO and POS bond debt service. Total expenditures increase from \$785.0 million in fiscal 2010 to \$842.0 million in fiscal 2011. The allowance includes \$6.8 million for the first POS bond debt service payment. GO bond debt service costs increase from \$785.0 to \$835.2 million.

### **General Obligation Bond Debt Service**

The fiscal 2011 allowance totals \$835.2 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.

**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 2011, ABF revenues are projected to be sufficient to support GO bond sale debt service.

**Exhibit 2**  
**Revenues Supporting General Obligation Bond Debt Service**  
**Fiscal 2009-2011**  
**(\$ in Thousands)**

	<b>FY 2009 Actual <u>Expenditures</u></b>	<b>FY 2010 Working <u>Appropriation</u></b>	<b>FY 2011 <u>Allowance</u></b>
<b>Annuity Bond Fund Activity</b>			
Beginning Balance	\$38,333	\$71,277	\$67,673
Property Tax Receipts	698,569	759,790	781,143
Interest and Penalties on Property Taxes	2,966	1,500	1,500
Local Loan Repayments	1,313	692	626
Miscellaneous Receipts	765	250	250
Bond Premium	74,130	11,629	0
Transfer to Reserve	<u>-71,277</u>	<u>-67,673</u>	<u>-17,764</u>
<b>Special Fund Appropriations</b>	<b>\$744,799</b>	<b>\$777,465</b>	<b>\$833,427</b>
<b>Federal Fund Appropriations</b>	<b>\$0</b>	<b>\$857</b>	<b>\$1,738</b>
<b>Total Appropriations</b>	<b>\$744,799</b>	<b>\$778,322</b>	<b>\$835,165</b>
Excess FY 2010 Appropriation <sup>1</sup>	0	7,522	0
Federal Fund Deficiency	0	-857	0
<b>Budgeted Debt Service Appropriation</b>	<b>\$744,799</b>	<b>\$784,987</b>	<b>\$835,165</b>

<sup>1</sup> Attributable to debt service from projected 2009 general obligation bond sales exceeding cost of actual bids.

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

Source: Department of Budget and Management, January 2010

The exhibit shows that debt service costs exceed revenues generated by State property taxes. Total ABF revenues are sufficient to support debt service because the State bond sales generated premiums. The capital budget bill (Senate Bill 142 and House Bill 152) appropriates \$53.3 million from the premiums generated in fiscal 2010 for the capital budget instead of using the premium to support debt service costs. At the end of fiscal 2011, \$17.8 million remains unspent in the ABF to support debt service in fiscal 2012. If \$53.3 million were not used to support capital projects, the

amount transferred to reserve to be available for debt service payments in fiscal 2012 would be \$71.1 million.

### **Program Open Space Bond Debt Service**

POS bonds totaling \$70 million were authorized as the Program Open Space Acquisition and Opportunity Loan of 2009 (Chapter 419 of 2009). The bonds are intended to backfill the transfer of up to \$70 million in Program Open Space State share unencumbered fund balance per the Budget Reconciliation and Financing Act of 2009 (Chapter 487 of 2009). It is anticipated that the full \$70 million in special bonds will be issued in spring 2010 since the bonds must 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 law requires that debt service on POS bonds' debt service be paid from POS land acquisition allocation of the State transfer tax. The debt may not be included as State tax-supported debt in the Capital Debt Affordability Committee's (CDAC) calculation until after the bonds have been issued.

The allowance includes \$6.8 million in fiscal 2011 for debt service costs. The estimate assumes a 15-year maturity, principal payments after one year, and a 5.00% TIC. Issues such as the bonds' rating, reserve requirements, and type of bond sold (such as traditional tax-exempt bond, BABs, or combination) have not been resolved. Considering the number of unresolved issues, as well as possible changes in market conditions, it is quite possible that this estimate will change.

## *Issues*

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### 1. Cost of Debt Is Expected to Exceed Revenues Dedicated to Pay for the Debt

Fiscal 2011 GO bond debt service costs total \$835 million, a \$50 million (6.4%) increase over fiscal 2010 costs. Debt service costs are projected to continue to grow as a result of increased GO bond authorizations. **Exhibit 3** 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 3 Actions Increasing General Obligation Bond Authorization 2001-2010 Legislative Sessions

<u>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
Chapter 485 of 2009	\$150 million one-time increase	One-time authorization to fund capital supported by general fund
SB 142/HB HB 152 of the 2010 Session	\$150 million one-time increase	One-time authorization to fund capital supported by general fund

Source: Department of Legislative Services, January 2010

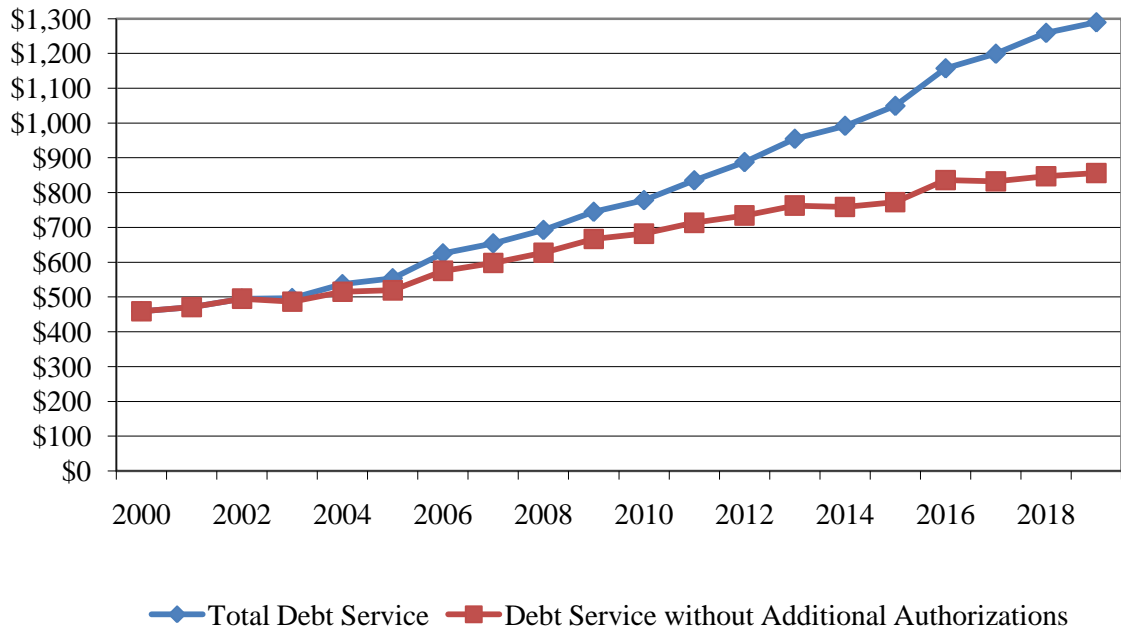
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While each individual action may appear modest, the cumulative effect of these actions is substantial. In 2000, State policy was to increase GO bond debt by \$15 million annually. This would have led to a \$610 million GO program to be considered at the 2010 session. Instead, the 2010 session authorization totals \$1,140 million, which is \$530 million greater than planned in 2000.

These increased authorizations result in higher debt service costs. **Exhibit 4** shows that fiscal 2011 debt service costs are projected to have been \$713 million without the additional authorizations, which is \$122 million less than the current projection. From fiscal 2010 to 2015, debt service costs are projected to increase by 6.2% annually. Without the increased authorizations, the growth rate for GO bond debt service costs would have been an estimated 2.5% annually. By fiscal 2015, increased authorizations add \$277 million to debt service costs with debt service costs totaling \$1,049 million.

**Exhibit 4**  
**Effect of Increased General Obligation Bond Authorizations on**  
**Debt Service Costs**  
**Fiscal 2000-2019**  
**(\$ in Millions)**



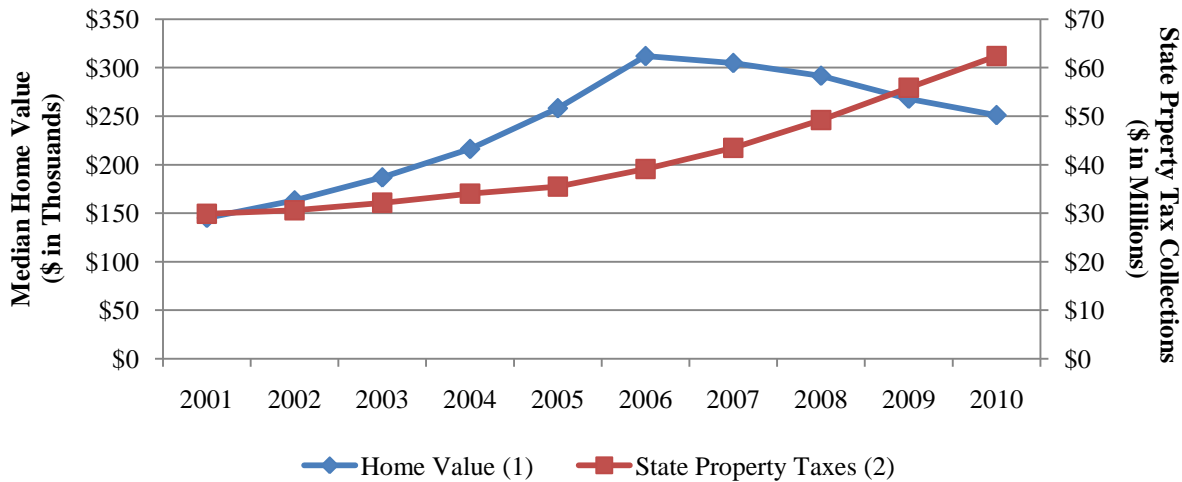
Source: Department of Legislative Service, January 2010

## 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 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. After increasing through the first part of the decade, property values began declining in 2007. Rising property values also led to increased State property tax revenues. **Exhibit 5** shows that, initially, revenues increased at a much slower rate than State property tax collections. From fiscal 2001 to 2006, home values increased approximately 17% annually while State property tax collections increased 5% annually. The slow growth in revenues is attributable to the State’s assessment process. Specifically, the process limits increases property owners pay because of triennial assessments and the Homestead Tax Credit. In Maryland, properties are reassessed every three years, so the assessed value lags behind the market values when properties increase in value. The homestead credit further limits revenues by limiting increases to 10% annually.

**Exhibit 5**  
**Home Values and State Property Tax Collections**  
**Fiscal 2001-2010**



Sources:

(1) Home Values are Maryland Association of Realtors estimates of home values for December of each fiscal year.

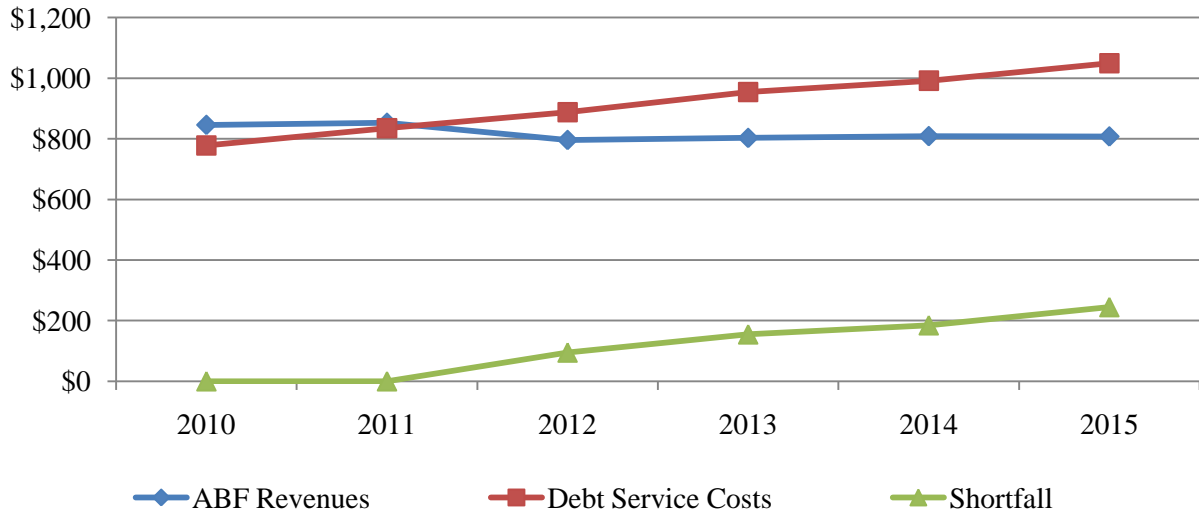
(2) State Property Taxes are total collections as reported by the Department of Budget and Management adjusted to one cent on the State property tax rate.

Property values have declined in recent years. State property tax collections have increased since home values have declined. The reasons are similar to the reasons for the lag in collections when property values increased. By 2007, assessed property values were below market property values and the Homestead Tax Credit had increased substantially. As market values decline, assessments are expected to catch up to market values and the homestead credit disappears. In the out-years, the State Department of Assessments and Taxation projects that State property tax collections will essentially be flat from fiscal 2011 to 2015; the revenues are expected to increase from \$781 million in fiscal 2011 to \$802 million in fiscal 2015, a rate of less than 1% annually.

### 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% annually between fiscal 2010 and 2015. State property tax revenues, which support 95% of GO bond debt service, are projected to grow by 1% annually over the same period. **Exhibit 6** shows that costs are projected to exceed revenues beginning in fiscal 2012. The gap increases from \$95 million in fiscal 2011 to \$245 million in fiscal 2015.

**Exhibit 6**  
**General Obligation Bond Debt Service Costs**  
**Exceed Annuity Bond Fund Revenues**  
**Fiscal 2010-2015**  
**(\$ in Millions)**



ABF: Annuity Bond Fund (includes federal funds)

Source: Department of Budget and Management, January 2010

Most of this gap will need to be closed by adjusting revenues. Debt service costs represent past issuances and are quite constant since the State issues fixed rate bonds. Debt service costs could be reduced if bond yields decline or if less debt is issued. But these would only have a small effect on debt service costs in the forecast years. For example, the Treasurer's Office advises that the most recent refinancing reduced annual debt service costs by \$25 million from fiscal 2010 to 2020. The savings associated with reducing debt authorizations is also limited in the short term. DLS estimates that reducing the current authorization by \$150 million, reduces debt service costs by \$3 million in fiscal 2012, and \$12 million in fiscal 2015. Deleting the entire 2010 session capital program reduces debt service costs by \$90 million in fiscal 2015, which is less than the \$245 million gap between revenues and costs.

The State can reduce general funds required in fiscal 2012 by applying additional bond sale premiums to GO bond debt service. If the coupon rate paid by bonds exceed the market rate (which is measured by the TIC), bond sell at a premium. Section 8-125 (e) of the State Finance and Procurement Article requires that unused premiums are transferred to the ABF to support debt service costs. The capital budget bill (Senate Bill 142 and House Bill 152) authorizes \$53.3 million in premiums for expanding the capital program instead of reducing general fund appropriations required to support fiscal 2012 GO bond debt service costs. **DLS recommends that the General Assembly delete the provision to expand the capital budget by authorizing bond sale premiums for capital projects. Absent this authorization, the premiums will have to be replaced by general fund appropriations to the ABF.**

## **2. State Debt Is Maxed Out, What Now?**

To develop State debt policies and advise the Governor and General Assembly, CDAC was established by Chapter 43 of 1978. CDAC meets in public 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.

CDAC has adopted guidelines to determine how much debt is affordable. These guidelines are self-imposed and reflect the State's intention to limit the amount of debt that is issued. The guidelines have evolved to reflect the State's objectives. From 1979 to 1986, the State had three affordability criteria: debt service could not exceed 8.0% of revenues supporting debt service; debt outstanding could not exceed 3.2% of State personal income; and new authorizations should exceed redemptions. The criteria were restrictive because the State wanted to reduce debt. In the late 1970s, the State was well above the debt service and debt outstanding limits, and the goal was to get down to the limits. The criterion limiting authorizations to redemptions was deleted in 1987 when the State reached the limits. The limits were modified again in 2008. The debt outstanding criterion was increased from 3.2 to 4.0% and the debt service criterion remained at 8.0%. Increasing the debt service limit to be more than 8.0% would require a larger share of State taxes supporting debt service and a smaller share supporting State programs. For this reason the committee was reluctant to increase the debt service limit beyond 8.0%.

## Changing Times: CDAC Reduces Out-year Capital Spending

As in previous years, CDAC submitted its report with a recommended level of GO bond authorizations in the fall of 2009. When the committee approved its recommendations in September 2009, it expressed concerns about the “extraordinary and rapidly changing fiscal conditions” and noted that revenues could still be revised substantially. The committee agreed to meet again in December and review its recommendation.

The Board of Revenue Estimates revised its revenue projections in September 2009, shortly after CDAC made its recommendation. The board substantially reduced estimated revenues. Projected fiscal 2010 revenues were reduced \$683 million, which is 5% less than the previous projection in March 2009. Out-year revenue projections were also reduced. The effect on debt policy was to reduce the level of debt service payments that are affordable.

In December 2009, CDAC met to review its authorization. The committee increased its recommended GO bond authorization for the 2010 session by \$150 million. This is not a departure from recent practice; the committee has increased the session authorization in eight of the last nine years. The committee did depart from recent practice when it reduced the out-year projects. **Exhibit 7** shows that total proposed authorizations decline by \$400 million from fiscal 2011 to 2015, in spite of adding \$150 million in fiscal 2011. The reduction to out-year authorizations was necessary to keep State debt within the limits set by CDAC because the reduction in projected revenues made the level of debt proposed unaffordable.

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**Exhibit 7**  
**December 2009 Revision to General Obligation Bond Authorizations**  
**Fiscal 2011-2015**  
**(\$ in Millions)**

<u>Fiscal Year</u>	<u>September Recommendation</u>	<u>December Recommendation</u>	<u>Difference</u>
2011	\$990	\$1,140	\$150
2012	1,020	925	-95
2013	1,050	925	-125
2014	1,080	925	-155
2015	<u>1,110</u>	<u>935</u>	<u>-175</u>
<b>Total</b>	<b>\$5,250</b>	<b>\$4,850</b>	<b>-\$400</b>

Source: Capital Debt Affordability Committee, December 2009

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**Exhibit 8** shows that the new issuances are projected to increase debt service costs from fiscal 2012 to 2014, but then reduce debt service costs after fiscal 2014. Another issue to consider is the effect of non-GO debt. State debt is not only GO bonds; it also includes other tax-supported debt. The largest share of this non-GO State debt is issued by the Maryland Department of Transportation (MDOT), which is projected to have \$1.8 billion in debt outstanding at the end of fiscal 2011. MDOT projects that its debt service costs will exceed 8% of revenues in fiscal 2012 and increase to almost 10% of revenues by fiscal 2015. If MDOT issues this debt, the State will limit other types of debt to remain within the debt limits.

**Exhibit 8**  
**Comparison of September GO Bond Debt Service Estimate and Current Debt Service Estimate**  
**Fiscal 2011 to 2019**  
**(\$ in Millions)**

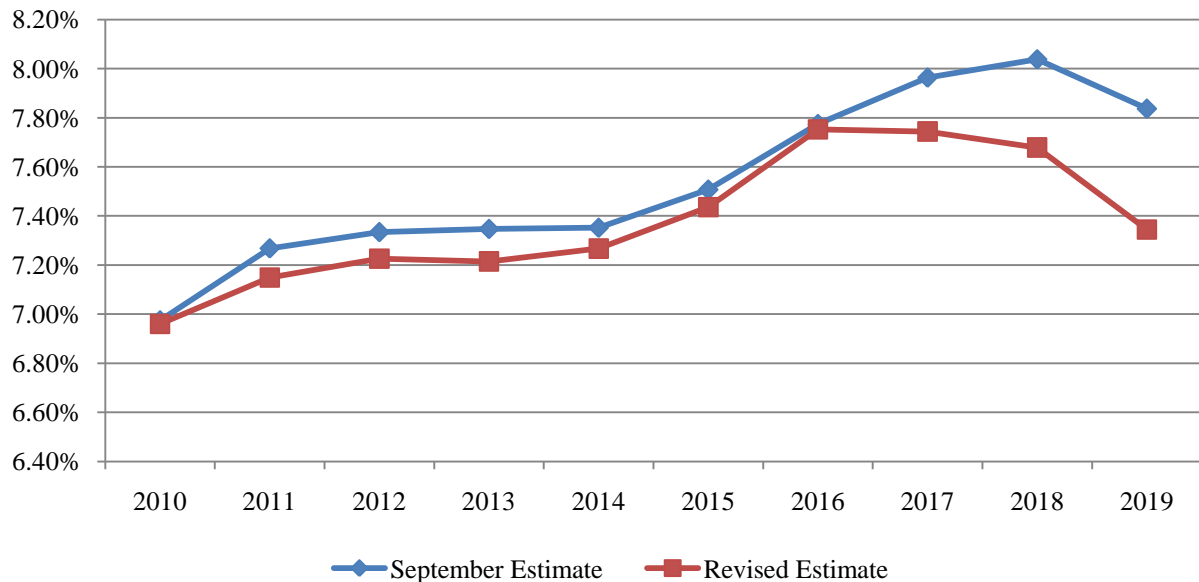
<u>Fiscal Year</u>	<u>September Estimate</u>	<u>Current Estimate</u>	<u>Difference</u>
2011	\$835	\$835	\$0
2012	887	888	1
2013	948	954	6
2014	990	992	2
2015	1,052	1,049	-3
2016	1,150	1,139	-11
2017	1,223	1,199	-24
2018	1,300	1,260	-40
2019	1,347	1,289	-58

GO: general obligation

Sources: Capital Debt Affordability Committee, September 2009, and Department of Budget and Management, January 2010

**Exhibit 9** shows that actions taken by CDAC have reduced the debt service below 8% of revenues.

**Exhibit 9**  
**Effect of Revised CDAC Authorizations on 8%**  
**Debt Service to Revenue Limit**  
**Fiscal 2010-2019**



CDAC: Capital Debt Affordability Committee

Source: Capital Debt Affordability Committee, September 2009; Department of Budget and Management, January 2010

## Policy Options

In recent years, the State has steadily expanded the capital program. In 2000, the State was well below its affordability limits and adopted a policy of incrementally increasing authorizations. As a result debt outstanding and debt service has been rising. State debt is now at the affordability limit. Current conditions no longer allow the State to annually increase authorizations and remain under the limits. The State is confronted with the following policy choices:

- Eliminate or Loosen Limits:*** The limits set by CDAC are self-imposed. They can be changed to allow the capital program to continue growing. The advantage of changing the limits is that this would keep the capital program growing. The disadvantage is that this would increase debt service costs even more. As previously discussed, the current level of debt exceeds ABF revenues and increasing authorizations just adds to this deficit. Eliminating or loosening limits could also increase the likelihood that the State's GO bond rating is downgraded. Rating agencies have noted that frequently revising debt ceilings is like not having a debt ceiling at all.

- **Maintain Current Limit:** The State could choose to keep the current limit and maximize capital spending under the current program. As personal income and revenue estimates are increased, more projects could be added to the program, which would then be withdrawn if revenues projections decline. The advantage is that this would maximize the program size. The disadvantage is that the program would be beholden to revenue estimates and, at times, would have projects coming in and out of the program.
- **Reduce Capital Spending:** Finally, the State could adopt policies similar to those that were adopted when CDAC first began. At the time, the objective was to reduce debt outstanding and debt service. For example, the first affordability criteria limited authorizations to the amount of debt that was retired each year. The advantage of this approach is that it would reduce spending and, over time, could bring the debt service costs back in line with State property tax revenues. The disadvantage is that it would take a while for this approach to yield results, and there would be less spending.

The State increased GO bond authorizations in almost every year of the last decade. The current capital budget expands GO debt by authorizing bonds for capital projected otherwise funded with cash. State debt is now at the affordability limits, and the State is no longer able to continue the practice of regularly increasing authorizations. The decline in revenues has also reduced debt capacity. **DLS recommends that the State maintain the current debt affordability limits. The State Treasurer’s Office should be prepared to brief the committees on the debt affordability process.**

### **3. American Recovery and Reinvestment Act’s Debt Provisions**

In February 2009, President Barack H. Obama signed the ARRA into law. In addition to authorizing federal spending and reducing federal taxes, the bill includes provisions that affect State and municipal bonds. Specifically, the Act authorized the following debt: Build America Bonds (BABs); Qualified School Construction Bonds (QSCBs); Qualified Zone Academy Bonds (QZABs); Qualified Energy Conservation Bonds (QECBs); Clean Renewable Energy Bonds (CREBs); Recovery Zone Facilities Bonds (RZFBs); and Recovery Zone Economic Development Bonds (RZEDBs). ARRA bonds include taxable bonds with a federal subsidy (BABs, RZEDBs, and RZFBs) and tax-credit bonds (QZABs, QSCBs, QECBs, and CREBs). Chapter 469 of 2009 confirmed BPW authority to issue these bonds.

#### **Federal Subsidy Bonds**

##### **Build America Bonds**

This is a new bond program that 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 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 federal government did not set a limit on the amount of BABs that can be issued.

Large sums of BABs have already been issued by State and municipalities. The University System of Maryland and the Maryland Transportation Authority have issued BABs. The Treasurer's Office issued \$50.0 million in BABs in August 2009 and another \$58.2 million in October 2009. The BABs were issued in the place of tax-exempt bonds. As discussed in the Performance Analysis section, DLS estimates that, after adjusting for the federal subsidy, the yield of the BABs was 0.92% or 92 basis points less than the cost of 15-year tax-exempt bonds. The Treasurer's Office plans to issue additional BABs in 2010.

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

RZEDBs are a subset of the BABs. RZEDBs offer a larger credit, 45% instead of 35%, than the BABs. RZEDBs 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. The State did not receive any allocation. If a locality waives its allocation, the State could issue the bonds or give the allocation to another locality. To date, no RZEDBs have been issued.

### **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. The State did not receive any allocation. If a locality waives its allocation, the State could issue the bonds or give the allocation to another locality. To date, no RZFBs have been issued. The Department of Business and Economic Development advises that they are in discussions with counties and have negotiated some reallocations of the bonds.

### **Tax Credit Bonds**

#### **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.

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The bonds are tax-credit bonds; the buyers receive a federal tax credit and may not receive an interest payment. The State pledges its full faith and credit when issuing QZABs and the bonds are considered State debt. Through December 2009, the State issued \$47.6 million in QZABs. In 2008, the State received a \$4.5 million allocation, which must be issued before the end of 2010. Legislation (Senate Bill 202 and House Bill 171) authorizing the issuance of the funds has been introduced. The ARRA authorized another \$15.9 million in QZABs in 2009 and 2010, the last of which must be issued before the end of 2012.

QZABs are attractive to the State because they are less expensive than issuing GO debt. Unlike GO bonds (which retire principal over a period of years), QZABs offer a bullet maturity (whereby the entire principal is retired at once). 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, the first QZAB issuance in 2001 generated \$18.1 million in principal for the State, with sinking fund payments totaling \$12.4 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.

Though the most recent QZAB sale did not yield as much savings as the initial sale, its costs were still less than the cost of GO bonds. In December 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%.

QZABs offer the State with a cost-effective alternative to GO bond debt. As such, they are a useful source of funding for the State's public school needs.

### **Qualified School Construction Bonds**

QSCBs are tax-credit bonds that support the construction, rehabilitation, or repair of public school facilities. Unlike QZABs, QSCBs do not require a 10% private match. These bonds can be issued to support the public school construction program in the place of GO bonds. The State was authorized to issue up to \$50.3 million in QSCBs in 2009 and another \$50.3 million in 2010.

The buyers of the bonds receive a tax credit, which reduces what the bond buyers will charge for the bonds. Under ideal circumstances, the bonds sell at par without any interest payments (referred to as a supplemental coupon). To date, QSCB sales have required either supplemental coupon payments (such as the Baltimore County sale which included a 1.25% coupon) or have sold at a discount (such as the Virginia Public School sale which generated proceeds equal to 91.0% of the bonds' principal). The Treasurer's Office advises that all of the nine previous QSCBs sales exceeding \$50 million either sold at a discount or required a supplemental coupon.

In December 2009, the State sold \$50.3 million in QSCBs at par without a supplemental coupon. The bonds will be retired in 2024 (fiscal 2025). The bonds will generate savings by replacing subsequent 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 Treasurer's Office advises that the fund will be generating interest, reducing annual payments further. At this point the sinking fund's investment rate of return has not yet been set.

### **Qualified Energy Conservation Bonds**

QECCBs 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 QECCB issuances, so marketability may be an issue.

The State Treasurer's Office proposes to use these funds to support Energy Performance Contracts (EPCs). The contracts are administered by the Maryland Energy Administration. EPCs provide capital financing for improvements that reduce energy costs. Finance costs are supported by the savings realized. In the past, financing was provided by a master energy lease. This financing has become unreliable in recent years. To continue financing the improvements, the office has proposed that QECCBs fund projects. **The State Treasurer's Office should brief the committees on the status of the State Energy Performance Contracts. The office should also brief the committees on the use of QECCBs to support Energy Performance Contracts and the marketability of QECCBs.**

### **Clean Renewable Energy Bonds**

CREBS is an existing tax credit bond program that finances renewable energy facilities. The 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. The State Treasurer has not issued any CREBS.

### **Conclusion**

The ARRA has authorized new debt. The Treasurer's Office has taken advantage of this debt and issued BABs, QZABs, and QSCBs. The cost of this ARRA debt is less than the cost of GO bonds, resulting in lower State debt expenditures. QECCBs may also be available to fund projects that improve energy efficiency. Other authorizations are still untried and their potential benefits are still unclear. **The State Treasurer's Office should be prepared to brief the committees on ARRA bonds.**

## ***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 2009</b>					
Legislative Appropriation	\$0	\$745,505	\$0	\$0	\$745,505
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	-705 <sup>1</sup>	0	0	-705
<b>Actual Expenditures</b>	<b>\$0</b>	<b>\$744,799</b>	<b>\$0</b>	<b>\$0</b>	<b>\$744,799</b>
<b>Fiscal 2010</b>					
Legislative Appropriation	\$0	\$784,987	\$0	\$0	\$784,987
Cost Containment	0	0	0	0	0
Budget Amendments	0	0	0	0	0
<b>Working Appropriation</b>	<b>\$0</b>	<b>\$784,987</b>	<b>\$0</b>	<b>\$0</b>	<b>\$784,987</b>

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

<sup>1</sup> Actual debt service costs for the July 2008 bond sale were less than projected.

**Fiscal Summary  
Public Debt**

<u>Program/Unit</u>	<u>FY09 Actual</u>	<u>FY10 Wrk Approp</u>	<u>FY11 Allowance</u>	<u>Change</u>	<u>FY10 - FY11 % Change</u>
01 Redemption and Interest on State Bonds	\$ 744,799,491	\$ 784,986,995	\$ 835,165,331	\$ 50,178,336	6.4%
01 Program Open Space Bond Payments	0	0	6,800,000	6,800,000	0%
<b>Total Expenditures</b>	<b>\$ 744,799,491</b>	<b>\$ 784,986,995</b>	<b>\$ 841,965,331</b>	<b>\$ 56,978,336</b>	<b>7.3%</b>
Special Fund	\$ 744,799,491	\$ 784,986,995	\$ 840,227,441	\$ 55,240,446	7.0%
Federal Fund	0	0	1,737,890	1,737,890	N/A
<b>Total Appropriations</b>	<b>\$ 744,799,491</b>	<b>\$ 784,986,995</b>	<b>\$ 841,965,331</b>	<b>\$ 56,978,336</b>	<b>7.3%</b>

Note: The fiscal 2010 appropriation does not include deficiencies.