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Alaska State Legislature

Senate Committee on State Affairs

Vic Fischer, Chairman • Fouch V • Juneau, Alaska 99811 • (907) 465-4954

Official Business

March 17, 1981

To: Fellow Senators
From: Senator Vic Fischer
RE: General Obligation Bond Defeasance legislation

Today, legislation is being introduced that would pay off the entire state debt, erase the millions we pay in debt service and clear the slate for all future generations of Alaskans by getting our financial house in order.

A number of ideas have emerged in this legislation session dealing with how to improve the state's financial image with the rest of the country. Ideas range from a cancer fund to bailing out Chrysler to a high powered advertising campaign. One thing they all have in common is that they appeal to the citizen, to the masses in an attempt to improve the state's fiscal profile.

An idea that is neither a scheme nor an attempt to sway public opinion, deals with defeasing of the state debt. Through a special defeasing [escrow] account, the state could create a monetary approach that would pay off the entire state debt. This account managed by a special bond counselor would invest in the taxable bond market (approx. 12% interest) while paying off the incurred debt in the tax-exempt bond market (approx. 8% interest). The potential is there at the moment to erase Alaska's debt (\$720 million) and take care of all future interest payments with a cash account of \$570 million.

One may ask why not make the investments directly out of the general fund and not set up a special account. It has become clear that we, the Alaska Legislature have the ability to spend all the money before us, no matter the amount. This special escrow account would set this money aside for a specific purpose: to pay off the state debt.

If we were to create this "defeasing escrow account," it would preclude us from going to the bond market for a period (minimum) of 18 months due to IRS regulations. That is why this concept goes hand in hand with substituting cash for all authorized but unissued general obligation bonds.

With continuing pressure from our Washington delegation assuring us that the mood in the "lower 48" is becoming increasingly jealous of our resource wealth, this would be one way of "putting our financial house in order." We would be showing our responsiveness to the nation's financial community by giving a clear signal that we were doing "first things first." We pay off our debts before we borrow money for other purposes.

The best way Alaska can prove that it deserves to manage it's new found oil wealth is to show the country's financial community the state can manage thru fiscal conservatism with an eye on the future. Then, the "outside" ideas of draining off part of the state's wealth will begin to diminish.



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An idea that is neither a scheme nor an attempt to sway public opinion, deals with defeasing of the state debt. Through a special defeasing (escrow) account, the state would create a monetary approach that would pay off the entire state debt. This account managed by a special bond counselor would invest in the taxable bond market (approx. 12% interest) while paying off the incurred debt in the tax-exempt bond market (approx. 8% interest). The potential is there at the moment to erase Alaska's debt (\$720 million) and take care of all future interest payments with a cash account of \$570 million. In addition to these earnings of \$150 million, there is a \$275 million savings through the relinquishing of the state's debt service.

One may ask why not make the investments directly out of the general fund and not set up a special account. It has become clear that we, the Alaska Legislature, have the ability to spend all the money before us, no matter the amount. This special escrow account would set this money aside for a specific purpose: to pay off the state debt.

FILE WITH BILL

STATE OF ALASKA

JAY S. HAMMOND, GOVERNOR

DEPARTMENT OF REVENUE

OFFICE OF THE COMMISSIONER

POUCH 5
JUNEAU, ALASKA 99811

April 2, 1981

The Honorable Vic Fischer
Chairman
Senate State Affairs Committee
Room 205 - Behrends Building
Juneau, Alaska

Dear Senator Fischer:

Re: Senate Bill No. 296 and Senate Bill No. 297

Senate Bill No. 296, an Act prohibiting the sale of certain general obligation bonds, was introduced in the Senate on March 17, 1981 and was referred to the Senate State Affairs; Senate Transportation and Finance Committees.

Senate Bill No. 297, an Act making special appropriations for capital projects for which general obligation bonds have been authorized but not issued and for defeasance of outstanding general obligation bonds, was introduced in the Senate on March 17, 1981 and was referred to the Senate Resources; Transportation and Finance Committees.

For the consideration of the Senate State Affairs Committee, I am enclosing a copy of a Fiscal Note prepared by Mr. Anselm Staack, Treasury Controller, Department of Revenue concerning both bills.

Sincerely,

R. D. Stevenson
Special Assistant

RDS/rdh

cc: The Honorable Bill Ray
Chairman
State Transportation Committee

Joseph K. Donohue
Deputy Commissioner
Department of Revenue

The Honorable Don Bennett
The Honorable M. E. Dankworth
Co-Chairmen
Senate Finance Committee

Anselm Staack
Treasury Comptroller
Department of Revenue

The Honorable Bettye Fahrenkamp
Chairperson
Senate Resources Committee

Discussion Paper:

General Obligation Bonding Policy and Debt Defeasance

Division of Policy Development
and Planning
Office of the Governor
February 23, 1981

Discussion Paper:

General Obligation Bonding Policy and Debt Defeasance

The State of Alaska is receiving (and over the next few years, expects to continue to receive) revenues in excess of current expenditures. It has been suggested that under these conditions it might be appropriate to pay for capital facilities with cash (general funding) rather than to borrow funds for these purposes through the general obligation bond method. Further, it has been suggested that the State consider the advance funding of the general obligation debt owed, thus, in essence, "paying off" and eliminating the State's bonded indebtedness. This process is known as "defeasance" in municipal bond parlance. The purpose of this memorandum is to outline the issues which need to be considered in weighing the pros and cons of these proposals.

The two proposals, paying cash in the future and defeasance of existing G. O. bonds are closely related, although the arguments surrounding each are somewhat different. The initial discussion here will focus on future G. O. bonding, since if it is decided that bonding should continue without interruption, this could constrain the State's ability to forward fund its existing indebtedness.

BONDING VERSUS PAYING CASH FOR CAPITAL FACILITIES

ISSUE I - FISCAL IMPACT:

A. Direct Impacts

1. The use of cash (general funds) instead of bonding would cost the State the opportunity to use the general funds for other purposes. The opportunity cost most easily measured is that of revenues which could have been earned by investing these funds. The State can borrow in the tax exempt market at a lower interest rate than that which it can earn on its investments. For every 1% spread on a 10 year \$100 million bond issue, the present value of this opportunity loss would be in excess of \$8 million. In nominal terms, a one percentage point spread would amount to more than \$22 million for each \$100 million of cash spent instead of borrowed.
2. There are other forms of legal arbitrage the loss of which would represent a cost to the State of paying cash. These include the allowable return on investment of borrowed funds during the lag between the time the funds are obtained and actually committed; and, the investment of 15% of the borrowed funds in certain reserve accounts.

3. On the other hand, use of cash would be administratively cheaper. The State Treasury Division estimates total bonding costs at approximately .35% of the value of bonds issued. These costs include such things as service fees, legal fees, preparation of prospecti, printing and advertising expenses.

B. Indirect Impacts

1. The major direct cost associated with paying cash (1 above) is relevant only if (a) the cash is invested at higher rates, or (b) is spent on projects which offer higher overall returns to the State (such returns being either economic or social in nature). However, if it is assumed that the funds will be spent on low valued activities, the State might be better off to spend the cash on the capital facilities and avoid creation of debt.
2. Another aspect of fiscal impact is concern over the total level of government spending. It has been contended by some, that bonded costs are not carefully considered as a part of overall State spending. A related concern is that there is tremendous pressure from special interest groups to spend all available cash and borrow in addition. Thus, to the extent that paying cash reduces the total fund availability (general funds plus borrowed funds), then overall spending will be reduced.
3. Even though bonding may not be considered by some as equivalent to other types of spending, debt service is a significant, non-discretionary element of the State's operating budget. The Governor's FY 1982 Budget Request contains \$128 million for debt service. Since policy makers have no choice but to pay debt service, it reduces their flexibility in directing and controlling operating expenditures. This issue becomes more important if an expenditure limit, such as is being currently discussed, is established.

ISSUE II - IMPACT ON BOND RATING:

There are several elements which in combination are used to establish the State's credit rating. These include per capita debt levels, general economic health (both current and prospective), and expectations regarding the future tax climate. Thus, the reduction of G. O. bonding and the resultant decline (over time) of per capita debt might contribute positively to the State's credit rating as well as those of its political subdivisions. It is also possible

that there would result positive spillover effects on revenue bond ratings, since the ability of the State to meet any "moral obligation" would appear to be strengthened. However, if the State intends to forego bonding, then the direct benefit of an improved rating is lessened. The possible spillover effects are still relevant, although quantification of this impact would be difficult.

The State's credit rating has improved over the last 20 years from a Baa rating (medium grade with speculative characteristics) to Aa (high grade) in 1980. The State's financial reputation has been carefully established, and significantly decreasing market involvement could result in a loss of market familiarity with Alaskan conditions. If the State's good credit rating were to decline, it would fall to future generations to reconstruct this relationship, perhaps in more difficult times.

The exposure of our financing plans to credit rating agencies and bond buyers offers a slight incentive for fiscal planning and self-discipline. The removal of even this minimal exposure, may leave less reason for caution against the "over-building" and long-term operation and maintenance impacts of capital facilities.

ISSUE III - PUBLIC INPUT AND EXECUTIVE CONTROL:

Bonds have the positive aspect of requiring voter approval. It is unconstitutional for the State to incur general obligation indebtedness without a vote of the people. This requirement assures public participation in the bonding decision.

The spending of cash for capital facilities would require no such public vote. Governor Hammond has, however, introduced legislation which would require a public vote on capital expenditures above a limited level as part of his expenditure limitation proposal (SJR 4). If this, or similar legislation were to become law, the loss of this public input would be avoided.

From the viewpoint of executive control of expenditures, the use of cash has more appeal since appropriations of general funds are subject to line item veto by the Governor. Thus, specific projects which were felt to be unworthy could be selectively eliminated. Conversely, the projects to be included in a bond issue are established by statute which must be accepted by the Governor as passed or vetoed in whole.

ISSUE IV - THE DISTRIBUTION OF THE COST OF PUBLIC FACILITIES:

One of the standard rationales for bonding for long-lived public assets is that those who benefit from public facilities (the users) should pay for them. Bonding meets this objective

by spreading the payments for facilities out over the asset life. Thus, in a general sense, the people who receive the benefits are those who pay the cost. If the State pays cash for these facilities, future users (be they immigrants or future generations) will not be directly paying their share of the cost.

The user pay approach loses some of its validity however when the source of the cash payment is considered. In essence, neither present nor future users (other than oil companies) are directly paying for capital facilities. However, looked at somewhat differently, both future and present residents would pay indirectly for capital facilities through the cost of the opportunity to use the funds for alternative purposes. Since present residents are not directly responsible for the existence of "surplus" revenues, it might be argued that intergenerational equity would be served by spending these funds on projects which will offer future as well as current benefits.

ISSUE V - EXTERNAL PERCEPTIONS OF STATE WEALTH MANAGEMENT:

Some have voiced concern that large general fund balances ("surplus" revenues) represent a serious perceptual problem at the federal level and in the national press. Congressional actions to limit the State's taxing power or to reduce federal revenues to Alaska have been discussed. The existence of the risk of unfavorable Internal Revenue Service rulings on tax or bonding questions has also been suggested.

The question thus arises as to whether a State policy of paying cash for capital facilities would improve the external perceptions regarding Alaska's financial position. Paying cash would reduce the general fund balance, as it increased direct expenditure levels. If the general fund balance is the major indicator looked at by outsiders this might reduce the criticism regarding the State's "surplus" wealth. Or, if paying cash reduces the total level of expenditures by reducing overall fund availability (as discussed in Issue II.B.2 above), this might improve the external view. Likewise, it can be argued that it is fiscally responsible to pay cash and thus refrain from burdening future generations with debt to be repaid when the oil revenues are declining or gone.

On the other hand, since bond costs are often not included in expenditure reports, the use of general funds for previously bonded projects would result in inflated expenditure figures. Those from outside of Alaska who wish to "share" some portion of the State's wealth, could look at increasing expenditures per capita as evidence of profligate behavior. Further, it is possible that individuals with some financial sophistication could view the state's willingness to incur the loss of arbitrage revenues by paying cash, as further evidence that Alaska's current income is indeed "surplus."

On balance it is unclear whether continued bonding or cash expenditures would be viewed more positively at the federal level.

SUMMARY:

The major issues regarding the cash versus the bonding approach which have been discussed here are listed in summary form below. These issues are presented in terms of the pros and cons of the cash approach, since a decision to use that approach would represent a change from the status quo.

ARGUMENTS FOR USING CASH RATHER THAN BORROWED FUNDS (BONDING) FOR CAPITAL FACILITIES

- Reduces administrative costs (.35% of bonds issued).
- Reduces total funds available for spending, thus has the potential of reducing low valued expenditures.
- Reduces the non-discretionary impact of debt service on the State operating budget.
- May positively impact the State's credit rating, with spillover effects for the ratings of municipalities and State revenue bonding agencies.
- Increases gubernatorial control over specific capital projects through line item veto.
- Reduces the debt service burden (from debt which might otherwise have been incurred over the next few years) on future generations.
- Reduces the general fund balance and future debt service requirements, and thus might improve external perceptions (in the national press) regarding Alaska's wealth and its management.

ARGUMENTS AGAINST USING CASH RATHER THAN BORROWED FUNDS (BONDING) FOR CAPITAL FACILITIES

- Imposes the substantial cost of lost interest earnings and revenues from legal forms of arbitrage.
- Reduces public participation in the spending decision since voter approval would no longer be required.
- Bonding for long-lived assets implements the user pay principle over time. If cash is used, future residents will not directly pay for the facilities from which they will benefit.

- To eschew bonding would not necessarily be seen as fiscally responsible, since substantial revenue losses would result from such a policy, and per capita expenditures would appear higher.
- Market exposure of State capital financing and the benefits of the State's carefully achieved credit status, would be reduced by eliminating bonding.

GENERAL OBLIGATION BOND DEFEASANCE

A second topic of this paper is the possibility of "paying off" the State's existing general obligation indebtedness. Defeasance of existing debt could be accomplished by making a current appropriation of the amount which will be required to retire the debt as it comes due. The Department of Revenue would use this appropriation to purchase a portfolio of securities which would generate sufficient cash flow to meet principal and interest payments on the portion of State G. O. debt which was to be advance funded. This portfolio would then be deposited with the State's principal paying agent according to an escrow and trust agreement.

There would be no financial disadvantage to the State in pursuing the defeasance of debt issued prior to May 2, 1978. However, Internal Revenue Service rulings in that year limited the yields on portfolios held for the purpose of defeasing debt issued after May 2, 1978. As a result, the State can purchase, or transfer, a high yielding portfolio to pay off the pre-May 2, 1978 debt owed, legally taking advantage of the interest differential between the State's investment earnings and the State's tax exempt borrowing costs. However, post-May 2, 1978 debt can be defeased only with securities earning little (if any) more than the bond rate. Thus, although the defeasance of debt incurred since the 1978 rulings could be handled similarly in a mechanical sense, any possible advantage from interest differentials would be insignificant.

Many of the general issues associated with the future of bonding apply also to the defeasance question. The major difference is that where paying cash in the future potentially represents a financial cost, defeasance of existing debt (at least that portion of the debt incurred prior to the May 2, 1978 effective date of the IRS regulations) does not represent a financial cost to the State.

A minor issue involves the windfall to investors from defeasance of State bonds. Defeasance would be accomplished by escrowing in trust United States Government Securities earning interest and maturing in amounts and time sufficient to retire the debt. The effect of this arrangement is to convert the State bonds defeased into debt with the same value as the United States Securities. When defeasance is accomplished, State bond holders will receive a windfall of increased price and a AAA rated bond. There is nothing counter to public policy in this result per se but it places a heavy burden on all "insiders" not to take advantage of special knowledge. It might be appropriate for those individuals who directly or indirectly might benefit from defeasance to disqualify themselves from participating in this decision.

Another consideration is that G. O. debt defeasance coupled with issuance of new debt, risks the Internal Revenue Service removal of the State's tax exempt bonding status. This would result if the Internal Revenue Service were to declare that new State general obligation bonds were arbitrage bonds and, hence, taxable. Therefore the State's bond counsels have cautioned the State that defeasance may require that the State refrain from issuing bonds, perhaps for one to three years.

In order to avoid undue repetition through restatement of the general arguments at length, the major pros and cons associated with defeasance are summarized below.

SHOULD THE STATE PURSUE DEFEASANCE (ADVANCE FUNDING) OF THE STATE'S GENERAL OBLIGATION DEBT?

Pro Defeasance

- ° The State could advance fund \$718,193,000 of indebtedness owed as of June 1981 at a cost of approximately \$562,527,000; or, if only pre-May 2, 1978 debt were advance funded, \$507,193,000 of indebtedness, at a cost of approximately \$351,527,000.
- ° The debt service period on outstanding bonds runs through the end of this century. Advance funding would relieve the debt service requirements which may become more burdensome as oil revenues decline over this period.
- ° Advance funding would remove a substantial amount of revenues from the general fund reducing the availability of funds to be spent, potentially on low valued projects.
- ° Defeasance would enhance the State's credit rating by reducing outstanding debt per capita. This could result in a lowering of borrowing costs by approximately twenty basis points (.2%). This improvement

might in turn heighten the probability of rating improvements for the State's political subdivisions and revenue bonding agencies.

- Defeasance would increase the State's debt capacity, perhaps for utilization in the future when borrowing may be increasingly important to fiscal health.
- Reduction of the general fund balance, and the removal of the debt service burden, might be viewed as conservative financial policies as compared with a large direct spending program, and thus could improve the external perceptions (at the federal level and in the national press) regarding Alaska's wealth and its management.

Con Defeasance

- The State could achieve the same interest differential by investing the funds necessary for defeasance through the Permanent Fund, some other account, or as general fund surplus. Or, there may be expenditures which offer a higher social rate of return (i.e., there may be higher valued alternative uses of the funds).
- Whether an actual credit rating change would result from advance funding of G. O. debt is uncertain. If there were a rating improvement, the maximum reduction in interest rates expected would be less than twenty basis points (.2%). The present value of this savings is relatively insignificant.
- Pre-funding of debt incurred after the 1978 IRS regulation would cost the State lost interest earnings, since under these rulings the interest on investments used for this purpose are limited to the tax exempt rate borne by the bonds in question.
- Defeasance may elicit a response from the Congress or the Internal Revenue Service declaring further State general obligation bonds, at least for a period of time, to be arbitrage bonds and, hence, taxable instead of tax-exempt bonds.