Commission on State Debt
Recommendation Outline

I. Background

a. Chapter 46, Laws of 2011 (SSB 5181) requirements

Chapter 46, Laws of 2011 (SSB 5181) established the Commission on State Debt and requires the Commission to examine:

1. Trends in the use of all kinds of state obligations, including the impact of debt service payments on operating budget expenditures.
2. Major uses of state debt, the debt service expenditure associated with the major uses, and a comparison of the debt service expenditures and other operating budget expenditures that address similar policy objectives as the major uses of debt.
3. Existing limitations and policies on the use of various kinds of debt and how those policies and limitations compare with other states with similar or higher credit ratings.

The legislation mandates that the Commission recommend improvements in state debt policies and limitations, including possible amendments to state constitutional debt limitations that will accomplish the following:

1. Stabilizes the capacity to incur new debt in support of sustainable and predictable capital budgets;
2. Reduces the growth in debt service payments to an appropriate level that no longer exceeds the long-term growth in the general fund expenditures;
3. Maintain and enhance the state's credit rating.

The bill also requires the State Finance Committee to recommend working debt limits for budget development purposes. A working debt limit is a debt limit used for modeling and planning purposes. It is set below the Constitutional debt limit to allow a cushion between the amount of debt service payments required and the Constitutional debt limit in the case financial conditions are less favorable than expected.

Substitute Senate Bill 5181 phases the working debt limit down from 8.5 percent in Fiscal Year 2016 to 7.75 percent by Fiscal Year 2022. The State Finance Committee may adjust the working debt limit due to extraordinary economic conditions, and is authorized to delay or reduce bond issuance in order to not exceed the recommended working debt limit.

The Commission must report its findings and recommendations to the State Finance Committee and the appropriate committees of the Legislature by December 1, 2011.

Chapter 46, Laws of 2011 (SSB 5181) is included in the appendix.

b. Constitutional Debt Limit

Washington State's Constitution, Article 8, Section 1, limits the amount of debt service the state may pay for certain types of debt. This debt limit was adopted by voters in 1972 and replaced a fixed debt limit of $400,000. The limit requires that principal and interest payments in any year may not exceed nine percent of the average of the prior three years of general state revenues (defined in the Constitution). An unofficial working debt limit has been used to maintain a cushion below the nine percent constitutional limit since the 2003-05 biennium. The cushion is intended to prevent the state from reaching nine percent in a situation where the state's interest rates increase or revenues fall more than expected.

Some types of debt are excluded from the Constitutional debt limit, most notably:

- Bonds payable from the gas tax and motor vehicle license fees;
- Voter-approved bonds;
- Bonds payable from income received from the investment of the Permanent Common School Fund;
- Debt issued to meet temporary deficiencies in the State Treasury;
- Debt payable solely from revenues of particular public improvement (Revenue debt); and
- State guarantee of voter-approved general obligation debt of school districts.

Washington State Constitution, Article 8, section 1 is included in the appendix.

c. Topics discussed

Over the course of five meetings, the Commission on State Debt discussed topics relating the state's debt, the debt limit, and the use of debt. Topics discussed include: Constitutional debt limit, statutory working debt limit, state debt sources and uses, laws and policies, debt service, state and local debt and the state's debt relative to other states, rating agencies, the State general fund budget, and the economic impact of debt financing.

II. Executive Summary

a. Meeting topics

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b. Summary of recommendations

III. Commission on State Debt Members

Chapter 46, Laws of 2011 (SSB 5181) established the Commission on State Debt. Commission members include the State Treasurer, who must chair the Commission; the Director of the Office of Financial Management; four legislators, one from each of the four major caucuses; and six independent experts, three appointed by the Governor and three appointed by the State Treasurer.

<u>Commission on State Debt Members</u>:

Jim McIntire, State Treasurer
Marty Brown, Director of Financial Management
Hans Dunshee, State Representative
Sen. Derek Kilmer, State Senator
Sen. Linda Evans Parlette, State Senator
Rep. Judy Warnick, State Representative
Jeff Johnson, President, Washington State Labor Council, AFL-CIO
Dr. Kathleen A. Ross, snjm, President Emerita, Heritage University, Toppenish
Kriss Sjoblom Vice President–Research and Economist, Washington Research Council
Ruta Fanning, Former Legislative Auditor and Director, Joint Legislative Audit & Review Committee
Tim Kerr, Former Deputy State Treasurer for Debt Management
Jim Shoemake, Independent Appointed by the Treasurer

IV. Findings

a. Is Washington a high debt state?

Whether Washington is considered a high debt state relative to other states is dependent on definitions and what debt is included in the debt calculation. Rating agencies rank Washington State's debt levels in the top ten among the 50 states based on the amount of outstanding tax-supported debt. Their definition of debt includes transportation debt that is paid with sources other than the general fund but does not include certificates of participation as well as other non-tax supported debt.

Moody's State Tax-Supported Debt Statistics For Fiscal Year 2010

	Total (mil. $)	Rank	Per Capita ($)	Rank	As % Personal Income	Rank	To GSP*	Rank	Debt Burden as % of Expenditures
Washington	$17,712	8	$2,626	7	6.20%	7	4.60%	10	
Mean	$9,984		$1,404		3.50%		2.78%		
Median	$4,308		$1,066		2.80%		2.17%		

Source: Moody's Investors Service, 2011 State Debt Medians Report, May 25, 2011

Research conducted by Professors Ronald Fisher, Michigan State University and Robert Wassmer, Sacramento State University, relies on census data to calculate the relative debt burden of the states. Census data includes not only general obligation bonds, but also revenue bonds and certificates of participation, debt the rating agencies do not include in their calculations. By this measure, when local debt is excluded, Washington is a moderate debt state relative to other states.

State Government Outstanding Debt, 2007, Selected State Comparisons

Long-term Debt Excluding Private Purposes Per Capita in 2009 dollars		Long-term Debt Excluding Private Purposes Percentage of GSP		Long-term Debt Excluding Private Purposes Percentage of Annual Revenue	
State	**Amount**	**State**	**Percentage**	**State**	**Percentage**
Massachusetts	$6,175	Massachusetts	11.0%	Massachusetts	77.7%
Delaware	$3,300	Oregon	5.4%	Delaware	36.6%
California	$2,452	California	4.7%	Florida	33.4%
Oregon	$2,420	Delaware	4.4%	**All States**	**29.0%**
Washington	**$2,133**	Florida	4.4%	California	28.5%
All States	**$2,013**	**All States**	**4.2%**	Oregon	28.0%
Florida	$1,872	**Washington**	**4.2%**	**Washington**	**27.9%**
Virginia	$1,772	Ohio	3.6%	Virginia	27.7%
Maryland	$1,618	Virginia	3.4%	Maryland	24.9%
Ohio	$1,508	Maryland	3.3%	Nevada	23.7%
Nevada	$1,394	North Carolina	2.8%	North Carolina	20.9%
North Carolina	$1,265	Nevada	2.6%	Georgia	19.7%
Minnesota	$1,260	Minnesota	2.5%	Ohio	19.2%
Georgia	$987	Georgia	2.3%	Minnesota	16.2%
Colorado	$871	Utah	2.0%	Colorado	14.9%
Utah	$866	Colorado	1.7%	Texas	13.7%
Texas	$696	Texas	1.4%	Utah	13.5%

Source: U.S. Census Bureau, State and Local Government Finances

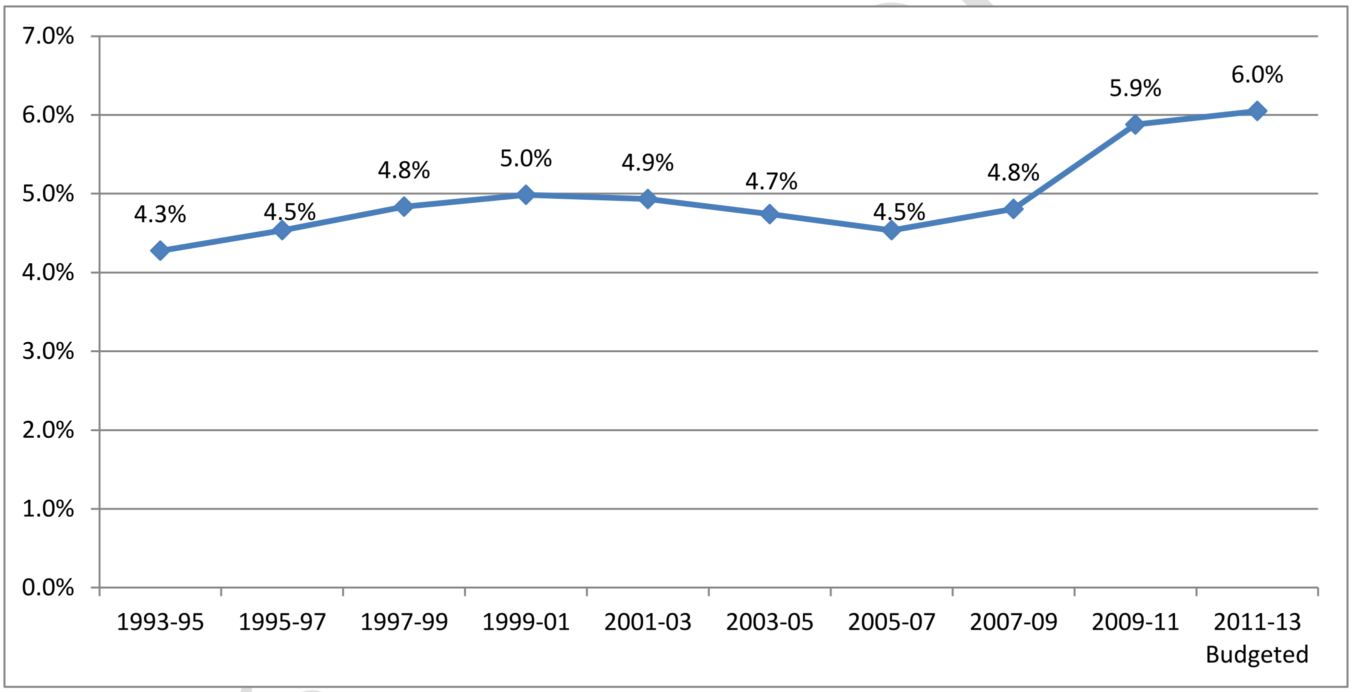
Ronald Fisher and Robert Wassmer Presentation to the Washington Commission on State Debt, October 21, 2011.

The differences in the ranking of Washington's state debt burdens between Moody's analysis and the Census data results from the different measures being used. The Census data captures a number of bonds that are not financed with general revenues or gas taxes, but with project based revenues. These types of projects would include things like toll-financed transportation projects and tuition and fee financed higher education buildings, which are widely used in some other states. Washington has used relatively few of these financing mechanisms to date. Because Washington finances nearly all of its transportation projects and most of its higher education buildings with gas taxes and/or general obligation bonds, they show up in both measures. Thus, from the perspective of an investor concerned about the capacity of general taxes to back state debt, Washington appears to have a higher debt load; reflected in the Moody's numbers. Alternatively, the overall debt load for Washington taxpayers

– including most forms of general and revenue specific debt – is about average; reflected in the Census numbers.

Concern has been expressed about the increasing percent of the state general fund required for debt service payments from the operating budget for bonds issued to support capital budgets projects. However, a significant part of that increase is due to declining general fund revenues. The general fund debt service in the 2011-13 biennium is approximately $1.948 billion or six percent of the near general fund expenditures.

Debt Service Paid as a Percent of Near General Fund

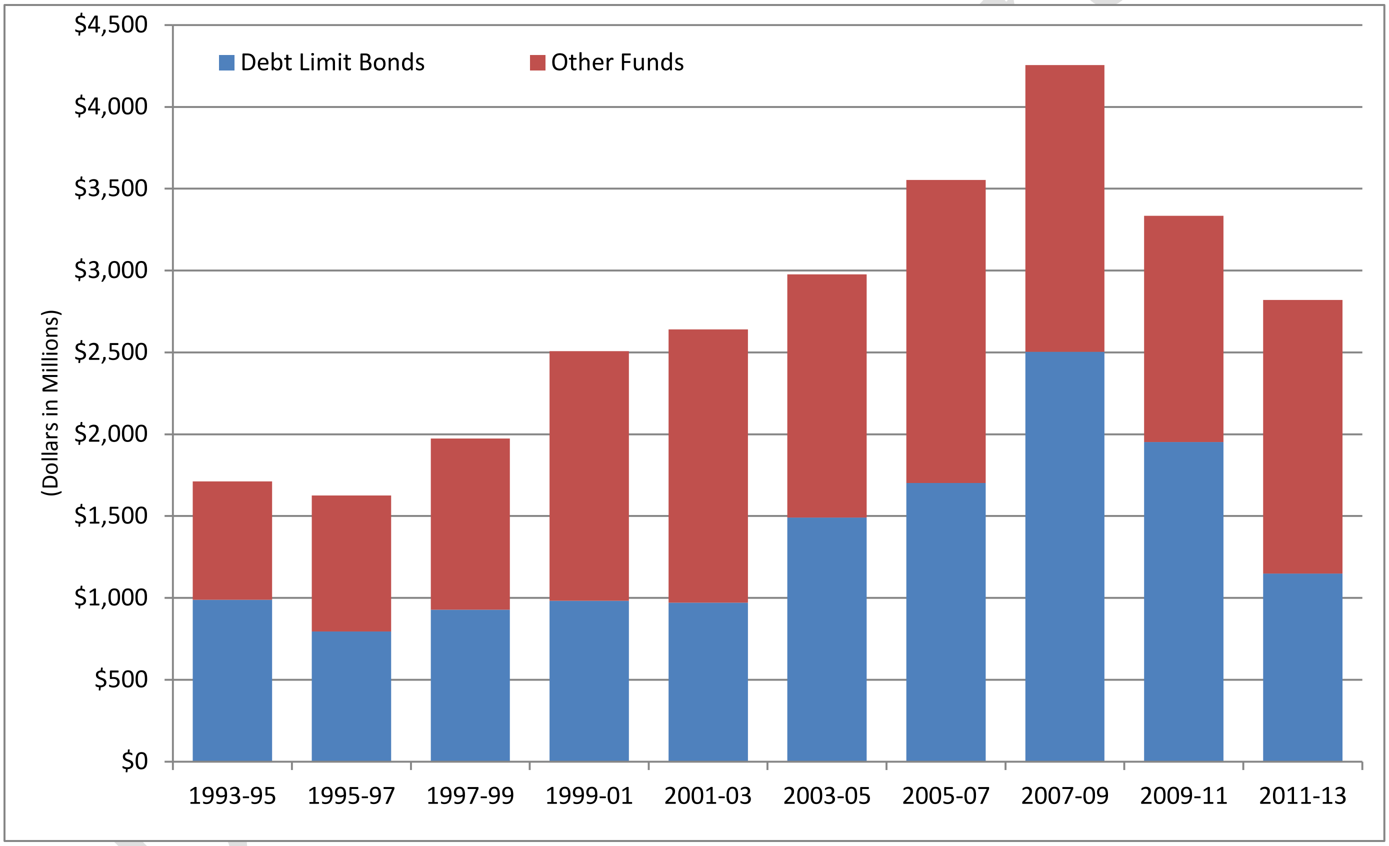


Source: Legislative Evaluation & Accountability Program (LEAP) Committee.
Note: 2011-13 reflects the enacted budget adjusted for the State Treasurer's 2012 Supplemental Operating Budget request to reduce budgeted debt service by $18,586,000. 2011-13 Near General Fund includes the Opportunity Pathways Account.

Advocates of capital budget projects argue that the debt financed investments are valuable and worth the required debt service payments and that the percentage of the general fund used for these payments will return to a lower level once state revenues recover.

As mentioned previously, the Constitutional debt limit expands and contracts with state general revenues collected by the state. The amount of debt service is projected several years into the future for planning purposes, based on expected revenues, interest rates, debt service payments, and future capital budget appropriation levels. Bond appropriations today are restricted by these projected variables. Most recently, the various purpose (non-transportation) capital budget appropriation levels have met the perfect storm of projected debt service from past bond issuances, declining revenue, and the point at which debt service reaches the working debt limit (also known as the "pinch point"). These circumstances have caused the amount of bonds available for appropriation to decline dramatically from the last two biennia and from the amount anticipated.

Various Purpose Capital Budget Appropriation History

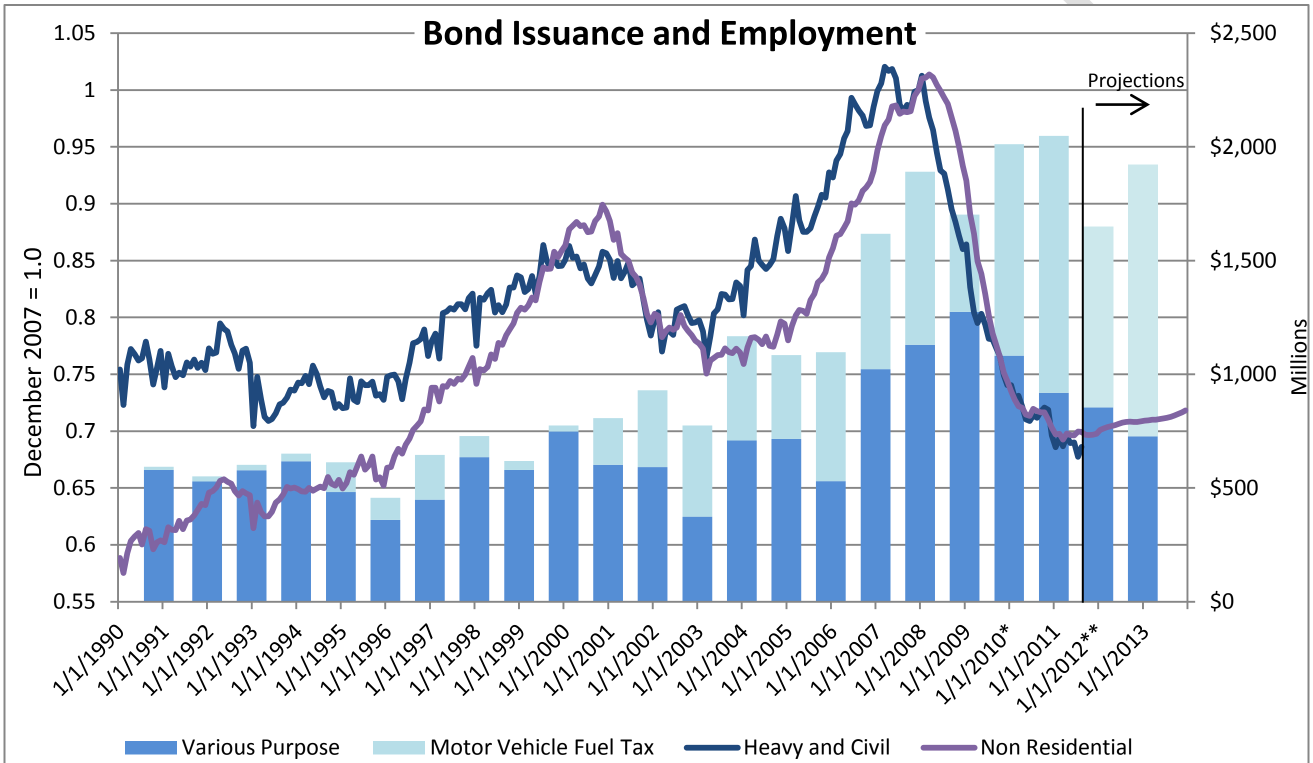


Source: Legislative Evaluation & Accountability Program (LEAP) Committee.

b. Economic impact of debt financing

The Washington State Office of Financial Management's Input-Output Model of the economic/jobs impact by industry indicates that for every $10 million increase of construction spending, 59 construction jobs are either maintained or created. These are one-time jobs that last as long as the construction project that's funded. The trade off for job creation in the short run is a long term reduction in other operating budget expenditures, including jobs supported in the operating budget due to the required debt service payments for bond funded construction projects.

The members of the Commission on State Debt discussed the appropriate timing of the use of debt and agree that debt financing for capital projects is timely during a recession when interest rates are low and construction costs are low, and when the state needs to support jobs and tax revenue.



*The 2010 MVFT issuance was over $2 billion but $1.13 billion was moved to 2011 for demonstration purposes because those bonds would have been issued in 2011, but were issued in 2010 to take advantage of the low Build America Bonds interest rate.
**2012 issuance is year-to-date plus projected isuance amounts.
2012 and 2013 issuance amounts are estimated projects, subject to change.
Source: Office of the State Treasurer

c. Other debt

The Commission on State Debt considered other debt obligations that fall outside the debt limit, including, debt issued for transportation projects, certificates of participation (COPs), and alternatively financed projects such as 63-20 financings.

The Commission found that, although debt issued for transportation projects is not included in the debt limit, rating agencies consider it in the overall state debt obligations. In fact, much of the debt issued for transportation projects is general obligation debt, meaning the state pledges the full faith, credit and taxing power to pay the debt service and is a market consideration for the state's investors. The overall debt needs to be considered by policy makers, but transportation debt should remain outside the debt limit for now.

Most debt service for state certificates of participation is paid from dedicated fund sources, but some COP debt service is paid from general fund revenues. Some of the Commission members want to count this general fund debt service within the debt limit.

V. Recommendations

a. Smoothing – Constitutional Changes to the Debt Limit

Because the state debt limit expands and contracts with state general revenues, and consequently, with the growth or contraction of Washington's economy, the Commission on State Debt recommends smoothing the amount of various purpose capital budget bond appropriations. As a result, during booming economic times, appropriations and the related debt service do not increase, which reduces the amount of bonds/debt service in down economic times. Smoothing the level of appropriations over time can be accomplished in several ways.

1. Increasing the number of years of general state revenue that the debt limit is based upon. As previously mentioned, the Constitutional debt limit requires that principal and interest payments in any year may not exceed nine percent of the average of the prior three years of general state revenues. Increasing the number of years allows for a softening of the impact of high years and low years.

Increasing the number of years included in general state revenue would require a constitutional amendment.

2. Adding a stable revenue source to general state revenues will smooth the amount that the limit is based upon. General state revenues are principally those revenues that are available to pay debt service and are not dedicated to other purposes. The state property tax is dedicated by statute to the support of common schools. So, although it is deposited into the general fund, it is not

included in general state revenue. (The state spends approximately $12 billion more per biennium on K-12 education than the amount state property tax generates.) If property tax continues to be dedicated to common schools, but the Constitution is amended to include the tax as general state revenue, smoothing would be accomplished to a certain extent.

3. Debt capacity could also be partially smoothed across economic cycles by modifying the definition of general revenue to account for transfers in and out of the budget and stabilization account (BSA). This account is established in the Constitution, article 7, section 12. One percent of general revenue is deposited each year in the account. The BSA fund may be transferred back to the general fund under three conditions: 1) with a simple majority vote of both houses of the legislature in any year in which employment growth is less than one percent; 2) with a 60 majority vote by both houses of the legislature; or 3) during certain declared emergencies with a simple majority. The effect of adjusting the definition of general state revenue to account for BSA transfers would be to suppress the growth in debt capacity during economic expansions and increase capacity during recessions. This change would require a constitutional amendment.

Washington State Constitution, Article 7, section 12 is included in the appendix. Washington State Constitution, Article 23, Constitutional amendments is included in the appendix.

b. Debt policy body

A different approach to managing the amount of debt available can be accomplished with a governing body that advises the Governor and the Legislature. In fact, chapter 46, Laws of 2011 (SSB 5181), requires the State Finance Committee to set working debt limits over a period of time for budget development purposes. The State Finance Committee is also given the authority to adjust the working debt limit due to extraordinary economic conditions, and is authorized to delay or reduce bond issuance in order to not exceed the recommended working debt limit.

Establishment of a debt policy body can be made in statute or in the Constitution.

c. Capital planning

d. Project specific financing

e. Transportation debt

Transportation debt, along with various purpose debt, needs to be considered by policy makers when determining the amount of future debt issuance and the possible impact on the bond market; however, transportation debt should remain outside the debt limit for now.

VI. Appendix

a. Article 8, Section 1 – Debt limit
b. Article 7, Section 12 – Budget Stabilization Account
c. Include Article 23 – Constitution Amendments
d. Chapter 46, Laws of 2011 (SSB 5181)