WASHINGTON STATE BUDGET & POLICY CENTER

Borrowing to Balance the Budget Can Make Sense, But Not by Itself

By Michael Mitchell

As policymakers in Olympia look for ways to fill an approximate $1 billion gap between the revenue the state is taking in and how much it needs to fund services that residents rely on, one alternative under consideration is "securitized" borrowing. This would involve getting a lump sum of money up front by selling bonds to investors and using future state resources – such as funds that are coming in from a tobacco lawsuit settlement – to repay interest and principal on these loans.

Because such a plan would require a long-term commitment of future revenues lawmakers should also look to enact short- and long-term revenue reforms at the same time. Borrowing without adding new revenues would not only make it more difficult for the state to balance future budgets and pay for vital services like health care, education and a clean environment, but also jeopardizes the high credit rating that makes borrowing affordable in the first place.

As state lawmakers debate the possibility of borrowing, they should consider three key factors:

- ***Borrowing appears practical for a number of reasons*:** Historically low interest rates make it more affordable to borrow against future revenues for operating purposes. Additionally, securitized borrowing would not be subject to the three-fifths majority vote of the legislature that the state Constitution normally requires for incurring debt. Nor would the borrowing be subject to the Constitution's debt limit. These advantages make it a viable option for generating significant up-front revenues to maintain investments in critical public services.
- ***Costly, one-time budget fixes could threaten Washington's credit rating*:** While a significant amount of money would be generated immediately, relying on one-time revenues from borrowing to address the current economic crisis could lower the state's credit rating, leading to higher borrowing costs in the future. Also, by devoting future revenues to pay off the debt, the state would forego large sums of money in later years for a one-time lump sum.
- ***Matched with specific programs and short- and long-term revenue reforms, securitized borrowing becomes more viable*:** Coupled with short-term moves like a boost in the sales tax and significant long-term reform of our state's inadequate revenue system – such as a new capital gains tax on the investment profits of

well-off Washingtonians – borrowing could help the legislature avoid additional cuts to core public structures. Also, by using securitization to fund programs with temporary, short-term revenue needs – such as the Basic Health Plan and Disability Lifeline programs – lawmakers can more responsibly borrow today, without pushing the gap into future budgets. This would create a more solid and dependable budget in the long run, and strengthen the state's credit rating rather than possibly weaken it through borrowing alone.

Traditional Benefits of Debt

Washington, like most states, routinely borrows money to finance large building projects such as new schools, prisons, roads and bridges. Unlike the federal government, where borrowing is used to fund everything from defense to federal employee salaries, the state Constitution limits the types of projects debt can finance. States don't borrow from banks; instead they sell bonds to people who buy them on the promise that they will get their money back, plus interest, at a future date.

The most common form of state bonding is called general obligation (GO) bonds. The money the state gets from these bonds goes into the capital budget, which pays for the construction and maintenance of large projects.

The state uses money from the operating budget – which pays for day-to-day investments in important services such as health care, education and public safety – to repay bondholders. The payments to bondholders are commonly referred to as debt service.

Borrowing in certain situations can be good fiscal policy for a number of reasons:

- ***Building projects are costly*:** Without the ability to borrow and spread the costs of construction out over time, many infrastructure projects would be too costly to pursue. By borrowing, the state is able to get the money it needs immediately and pay back these loans over an extended period of time, similar to the benefit an individual gets with home mortgage.
- ***Benefits and costs are shared over time*:** Many public buildings, such as schools and prisons are used for decades. Using debt and allowing costs to be spread among generations of Washingtonians ensures that those who benefit over time also share in the costs.
- ***States can take advantage of low interest rates*:** Constantly changing interest rates make borrowing costs fluctuate over time. By timing when they borrow, states can take advantage of lower interest rates and reduce the costs of building projects.

What is securitization and how does it differ from traditional state borrowing?

Unlike other state borrowing, money raised through securitized borrowing could be used for a number of purposes, including health care, education and other key structures the public rely on.

Securitization of future revenues – such as tobacco settlement payments -- involves establishing a Special Purpose Entity (SPE) to issue and repay debt. The state must sell future revenues, such as money it has been taking in from the settlement of a multi-state lawsuit against tobacco companies, to the SPE. The SPE then sells bonds to generate one-time funds that are transferred back to the state.

This type of borrowing offers lawmakers an opportunity to quickly generate resources needed to preserve our essential investments in health care, education, and other important priorities. As with all borrowing, there are challenges and drawbacks that policymakers must consider.

Borrowing Against Tobacco Settlement Revenues in 2002

In the late 1990s, 46 states, including Washington, reached a settlement with the major tobacco companies over violations of antitrust and consumer protection laws. Washington state was awarded approximately $4 billion, to be received over a period of 25 years.[1]

During the "Dot-com" recession, the state did not have enough revenue to balance the 2001-03 budget. In response, the state created the Tobacco Settlement Authority (TSA) as an SPE to use a portion of the future tobacco settlement money to generate $450 million for the state through a bond sale (bonds issued are commonly referred to as tobacco bonds). Washington dedicated approximately 29 percent of tobacco settlement revenues to the TSA over the life of the bonds to pay interest and principal.

Since the interest and principal are not paid by the state but from the tobacco settlement money, they do not count against constitutional debt limitations. Lawmakers were able to pass legislation authorizing the sale of tobacco bonds with a simple majority vote.

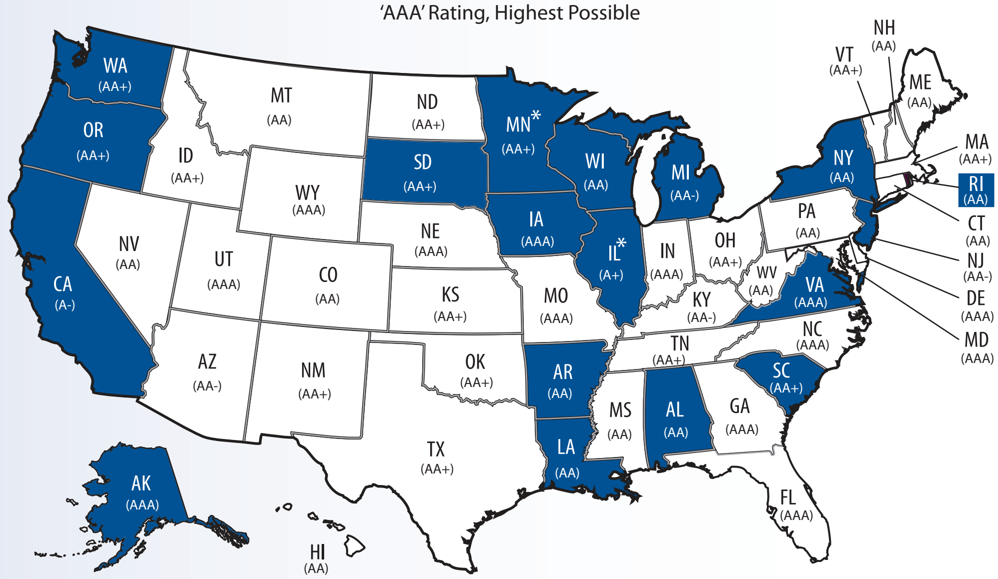
The TSA still operates today in order to repay the principal and interest owed to bond holders.[2] Quickly securitizing an additional portion of tobacco settlement money is possible since the TSA has experience in selling and managing tobacco bonds, and has the infrastructure already in place to do so.

Since only a portion of the future revenues from the tobacco settlement were dedicated to the earlier bond issue, Washington can use the remaining funds to help with its current shortfall. In calendar year 2011, settlement payments made to the state – minus the portion received by the TSA – totaled approximately $105 million.[3]

18 States Have Securitized Tobacco Settlement Revenues

Credit Ratings as of January 5, 2012

'AAA' Rating, Highest Possible



Source: Budget & Policy Center analysis; data from Standard & Poor's, PRAG, NCSL

*Minnesota and Illinois are the two most recent states to securitize tobacco settlement revenues; FY 2012 and FY 2011 respectively

Why borrow this way?

Securitization can be done without a three-fifths majority vote

To sell general obligation bonds, the Washington State Constitution requires a three-fifths majority vote in both houses of the legislature. Because it allows only a handful of lawmakers to block action, the three-fifths requirement (like other supermajority vote requirements) is a significant barrier to generating badly needed short-term revenues. Under securitization, the state could authorize the TSA to issue tobacco bonds with a simple majority vote.

Constitutional debt service limits do not apply

Another constraint on state borrowing is the constitutional debt limit, enacted to prevent the state from accumulating high levels of debt. The State Constitution limits bond principal and interest payments each year to 9 percent of the average amount of general state revenues for the three prior years.[4] However, with securitized borrowing, the SPE, not the state government, owns the debt, so it does not count toward the debt limit.

Still, the money used to repay these loans originates with the state. The amount of revenue sold to the SPE is more than a dollar-for-dollar reduction in funds available for other purposes in future budgets. It is important for policymakers to understand they will no longer have this money at their discretion for the life of the bonds.

Securitization distances the state from obligations

If Washington state authorized a SPE to issue bonds, repayment of these loans would not be guaranteed by the state. Unlike general obligation bonds, if future revenues are insufficient to repay the interest and principal on the loan, the state is not on the hook for repaying bondholders. Securitization allows the state to separate itself from the risk of default.

Despite this legal separation, should securitized funds be insufficient for repaying bondholders, the state may still feel significant pressure to intervene and repay loans. Having bonds in default that are even tangentially tied to the state could hurt the state's financial reputation. This potential responsibility to intervene is known as a moral obligation.[5]

Costs of borrowing are at historic lows

The long-term costs of borrowing are near record lows for state and local governments across the nation. At the end of 2011, the interest rate on a typical, 20-year state GO bond was approximately 3.9 percent. For the most part, rates had been consistently above four percent since 1967.[7] Lower interest rates mean lower debt service payments.

Historically, bonds backed by securitized cash flows have not carried interest rates as low as strongly rated state-issued bonds. During the 2001-03 tobacco bonds issue, the average annual interest cost was 6.75 percent. If the state had issued an identical amount of general obligation bonds with similar specifications, the net interest costs would have been approximately 4.8 percent.[8]

Recently, however, other states have managed to borrow against tobacco settlement payments at relatively low rates. Last summer, Minnesota used future tobacco settlement revenues to get approximately $750 million in up-front funds. Interest rates on these bonds ranged from 3 percent to 5.25 percent, depending on the length of the bond.[9] It is likely that if Washington pursued securitization of tobacco settlement revenues at this time, similar interest rates would be attainable.[10]

Challenges to borrowing against tobacco settlement payments

Future settlement payments are uncertain

As part of the tobacco settlement, payments are continually adjusted to reflect declines in cigarette sales, federal or state legislation increasing tobacco taxes, and potential settlements tobacco companies may have to pay out in the future. While the companies are currently making sizeable payments (see Figure 2), questions loom about future payments as national attitudes and behaviors around smoking continue to shift.

Because of this uncertainty, one major ratings agency, Standard & Poor's, has a policy of capping the rating potential for tobacco bonds at 'A', several rungs lower than its highest rating, citing unpredictability about smoking trends and subsequent settlement payments to states.[11] Due to this ratings cap, tobacco bonds must have a higher interest rate to compensate purchasers for their perceived risk. In comparison,

Box 1: Debt Service Takes Up an Increasingly Larger Share of our Operating Budget

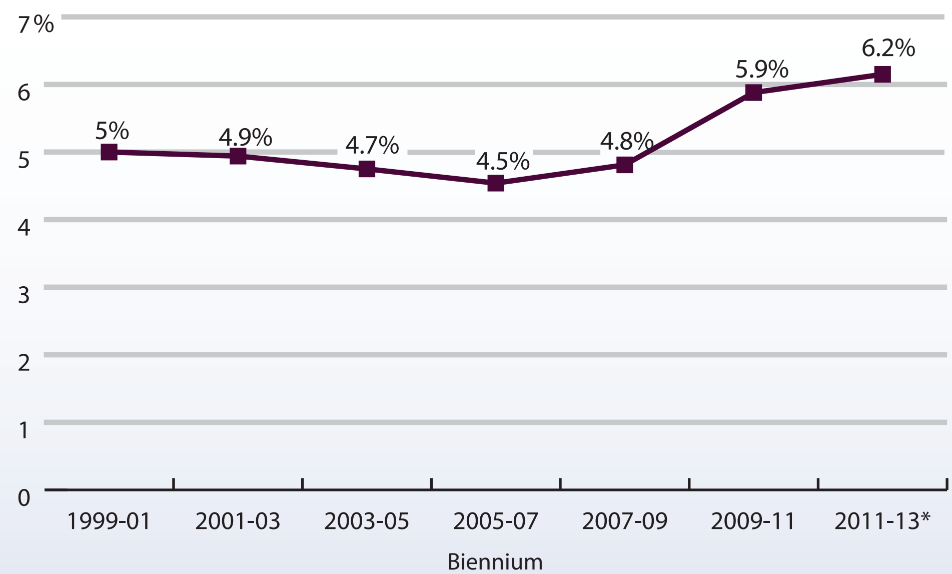
Principal and interest payments on Washington state's debt are typically made through the operating budget. In the 2011-13 budget, such payments account for nearly $2 billion dollars in spending -- slightly over 6.1 percent of total Near General Fund-State expenditures. As Figure 1 shows, debt service as a share of total Near General Fund-State spending has increased by approximately 1.2 percentage points since the 1999-01 biennium.[6]

While increased borrowing played a significant role in the growth of these payments, it is important to note that the decrease in revenue during the recession also pushed the state closer to its debt limit. As revenues fell, even if debt service payments remained the same, the state would move closer to hitting its debt service limit because the debt would become a higher percentage of state spending.

Debt service competes directly with funding for critical investments in schools, colleges, health care, and public safety. It also reduces the state's flexibility in tough economic times, since Washington is constitutionally obligated to pay its debt service. This reduces the overall funds available to policymakers trying to meet public needs.

Figure 1: Debt Service Has Increased as a Share of State Spending

Debt services as a share of Near General Fund-State spending



Source: Budget & Policy Center analysis; data from LEAP *Budgeted

Washington State General obligation bonds are rated AA+, four notches higher than tobacco bonds.

Giving Up Future Revenue

The cost of borrowing is not only felt through increased debt service payments. In order to receive proceeds from a bond sale, the state must forego significant future revenue. In the case of the 2001-2003 tobacco bonds, while the state received $450 million in up-front revenues, the TSA estimated that the 2002 value of the future tobacco settlement payments sold to it was $580 million. Meaning that on the loan itself, for every dollar borrowed, interest costs totaled approximately 28 cents.[12]

One-time budget fixes may threaten the state's credit rating

Washington enjoys a credit rating of 'AA+' from both Fitch Ratings and Standard & Poor's, and a rating of 'Aa1' from Moody's Investors Service.[13] Those ratings are the second-highest possible, with the companies citing the state's well-educated workforce, fully funded pension plans and responsiveness to budget challenges as credit strengths that set Washington apart.[14]

Those strengths are weighed against Washington's challenges. If challenges begin to outweigh strengths, the firms may move to lower Washington's rating to warn potential investors, pushing up borrowing costs.

Increased debt service payments would cost the state millions of dollars. Assuming annual sales of $1 billion in general obligation bonds over a four-year period, the cost of a one-notch downgrade – from AA+ to AA -- for the state would be approximately $110 million. Over the same time period, a two-notch downgrade would cost the state over $285 million.[15]

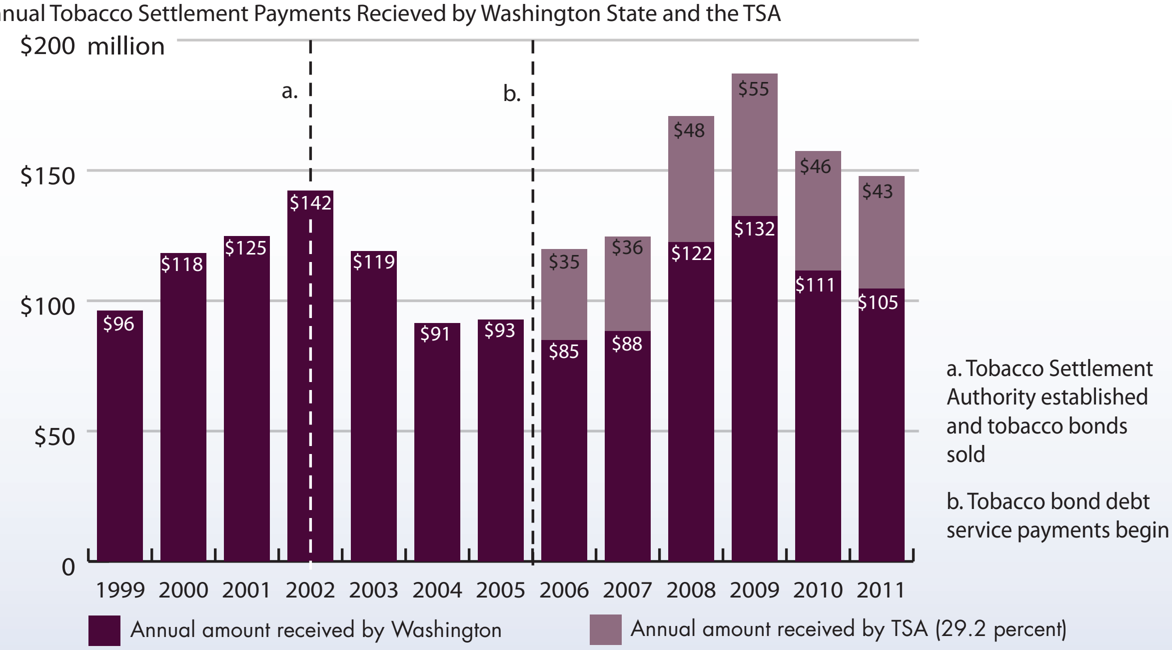
While Washington's credit strengths have traditionally offset its challenges, this balance may be starting to shift. In January 2012, Fitch and Moody's lowered the state's credit outlook from "stable" to "negative," citing its flawed revenue policy and excessive reliance on cuts to public health and education in recent years.[16] (A negative outlook, as opposed to a lower rating, is considered a warning and generally does not raise borrowing costs.)

The rating firms cited a "concentrated revenue system," meaning the state relied too much on a narrow range of taxes, and reduced budget flexibility from significant spending cuts as major factors driving the negative outlook. Moody's noted "Diminished financial flexibility given depletion of financial reserves, significant use of one-time actions to balance current biennial budget, and implementation of sizable budget reductions over the past several years."[17]

So, while securitization may play a role in bringing in additional revenues, it is indeed a one-time solution that fails to address Washington's inadequate revenue system. Failure to address this issue could have major

Figure 2: Tobacco Settlement Payments Have Fluctuated Over Time

Annual Tobacco Settlement Payments Recieved by Washington State and the TSA



Source: Budget and Policy Analysis; Data from DOR consequences. In the summer of 2011, Minnesota lawmakers agreed to borrow against a portion of future tobacco settlement revenues to help erase a $5.1 billion shortfall. Later that year, Minnesota's credit rating was downgraded from AAA to AA+ by Standard & Poor's.[18] The ratings agency cited the state's "reliance on non-recurring measures to balance its budget" as a primary reason.[19]

Steps can be taken to improve securitization

Tie borrowed funds to a short-term need

Because of the one-time nature of securitized borrowing, the money diverted from other services and investments to back the bonds has to be made up in subsequent budgets. Using one-time budget fixes does not actually close the revenue gap, but merely pushes it off to future budgets. To address this issue, state lawmakers could identify services that require only short-term funding and use securitization for these initiatives, for example, Washington's Basic Health Plan and Disability Lifeline.

By funding the Basic Health Plan and Disability Lifeline, federal Medicaid dollars would help maintain these programs by providing for half of the costs for the remainder of the two-year budget. The low-income populations currently being served will be fully covered by the federal government in 2014. Over time, federal matching funds will ramp down before landing at 90 percent of costs in year 2020 and thereafter.

The Basic Health Plan (BHP) helps provide health care coverage to low-income, working adults who do not qualify for traditional health care programs, do not get coverage through their employers, and are unable to afford private insurance. Disability Lifeline (DL) provides much-needed health services to people who have physical and mental disabilities. The Governor has recommended eliminating both programs in light of the state's revenue shortfall.

In January 2011, Washington state's plan for early implementation of Medicaid expansion was approved by the federal government. Under the expansion, federal Medicaid funds would help maintain BHP and DL by picking up half the costs of these programs. If these programs are eliminated, the state will not receive the federal funds.

Securitizing roughly 30 percent of the state's remaining portion of tobacco settlement payments would generate between $220 and $275 million, enough to cover BHP and DL for the remainder of the biennium. By using borrowed funds to prevent the short-term elimination of BHP and DL, the state would receive federal matching dollars for the remainder of the two-year budget and keep the services operating until 2014, when federal health care reform goes into full effect. At that time, low-income individuals served by these programs will be fully covered at the federal level.

Between 2014 and 2016, federal funds will cover 100 percent of the Medicaid costs for these low-income individuals, before dropping to 95 percent cost coverage in 2017. In year 2020 and beyond, federal matching funds will settle at 90 percent.

Match securitization to short and long-term revenue reforms

To prevent further cuts to education, health care and other essential needs, and protect Washington's high credit rating, policymakers should look to new resources immediately, as well as long-term revenue reform.

To help deal with the looming deficit, a one-cent increase in the state's sales tax would generate approximately $1 billion. Similarly, by modernizing the state sales tax to include entertainment services, hair and nail salons, massages, and other services, the state would generate approximately $100 million in new revenues annually.[20]

While it could not be implemented quickly enough to help with the current budget problem, a new excise tax on capital gains would generate hundreds of millions of dollars for sustained investments in education and public safety, while at the same time bolstering the state's rainy day fund. Such a tax would also address the upside-down nature of Washington's revenue system, which require middle- and lower-income residents to pay a higher percentage of their income in state and local taxes than those who are better off. The overwhelming majority of capital gains are enjoyed by the state's wealthiest residents; 97 percent of Washington households would see no tax increase under the capital gains proposal.

Additionally, subjecting tax breaks to the same level of scrutiny and accountability as health care, education and other spending – and eliminating those that aren't serving their intended purpose – would bring much needed accountability and transparency to our revenue system.

Conclusion

The fiscal challenges facing our state provide an opportunity to place Washington on a path for strong economic growth and shared prosperity. Relying solely on damaging service cuts and one-time solutions jeopardizes Washington's ability to create jobs and build a strong economy, threatens the health and safety of all Washingtonians, and places at risk the fiscal position of the state.

Lawmakers need to find responsible and sensible solutions to balance the state's budget and invest in the building blocks of economic growth. Using future revenues to pay for borrowing through the sale of bonds can be one of those solutions, but only if done together with significant short- and long-term revenue reforms. By increasing and modernizing the sales tax the state can raise significant revenues quickly. In the long run, enacting a state tax on capital gains and requiring sunset provisions on all tax expenditures will make our revenue system stronger, more equitable, and more transparent. Like so many problems, this one has no single solution, but the right combination exists if policymakers are willing to act.

Acknowledgments

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Endnotes

1. Tobacco Settlement Authority, Final Report 2003
2. The debt service currently being repaid by the TSA, set to be completely paid off approximately in year 2024
3. Department of Revenue
4. Washington State Constitution, Article VIII, Sec. 1, (b)
5. Wisconsin Legislative Fiscal Bureau
6. Budget & Policy Center analysis; data from Legislative Evaluation & Accountability Program (LEAP) Committee
7. Federal Reserve
8. Tobacco Settlement Authority, Final Report 2003
9. Minnesota Management and Budget
10. The interest cost would be a function of the bond rating given by the ratings agency plus a myriad of other factors regarding the structure of the bond sale, timing of the bond issue, and other economic and market factors.
11. Overview of S&P's Tobacco Securitization Rating Methodology, Standard & Poor's 2011
12. Tobacco Settlement Authority, Final Report 2003
13. Office of the State Treasurer of Washington
14. Standard & Poor's Ratings Report 2011; http://www.tre.wa.gov/documents/SnPBonds_Sep11.pdf
15. Office of the State Treasurer of Washington, Debt Affordability Study http://www.tre.wa.gov/documents/debt-AffordStudy-2011.pdf
16. "Fitch Revises Outlook on State of Washington to Negative" Fitch's Ratings 2012
17. Moody's Investor Services; http://www.moodys.com/research/MOODYS-REVISES-STATE-OF-WASHINGTON-RATING-OUTLOOK-TO-NEGATIVE-FROM--PR_236450 2012
18. It should also be noted that when a state's credit rating is altered, this has secondary effects on the cost of borrowing for counties and municipalities across the state.

19. "Minnesota's bond rating drops amid budget instability" Minnesota Budget Project, 2011

20. Increasing and Modernizing the Sales Tax, Budget & Policy Center 2010; http://budgetandpolicy.org/reports/increasing-and-modernizing-the-sales-tax