THE 2004-2005 STATE BUDGET

Bond Financing

The Governor's Budget includes a total of $13.2 billion of bond proceeds to finance the current General Fund deficit and a portion of proposed General Fund (GF) spending in 2004-05, as follows:

- **Economic Recovery Bonds (ERBs).** The budget allocates a total of $12.3 billion of proceeds from ERBs, pending approval of Propositions 57 and 58 on the March 2nd ballot. Of this amount, $9.2 billion is used to finance the 2002-03 budget deficit (plus a small reserve of $679 million), $3 billion to finance the 2004-05 budget deficit, and $1.7 billion is reserved for financing various deferred obligations in 2005-06 or 2006-07. (The budget assumes total net proceeds of $14 billion from the $15 billion ERB authorization. The remaining $1 billion would be available for issuance costs, establishing bond payment reserves, or providing credit enhancements.) The budget includes $1.256 billion (GF) to cover debt service on the ERBs in 2004-05 (the funding is in K-14 education to replace property tax revenue under the Triple-Flip mechanism discussed below).

- **Pension Obligation Bonds (POBs).** The budget also proposes to sell $929 million of POBs to offset the state's employer contributions to the Public Employee Retirement System (PERS) in 2004-05. The administration proposes to finance repayment of the POBs with future pension cost savings resulting from (1) repeal of SB 400 (Ortiz), which enhanced retirement benefits for state employees and (2) an increase in the employee contribution rate. The budget estimates that debt-service costs for these POBs would start in 2005-06.

- **Bonds Enable State to Pay Off Short-Term Borrowing Due in June 2004.** During June a total of $14 billion of short-term notes issues by the state come due. Absent bond proceeds from the ERBs (or some alternative borrowing mechanism) the state would be roughly $6 billion short of the amount needed to fully pay off these notes. This shortfall would trigger backup credit agreements with financial institutions. These backup agreements impose significantly higher borrowing costs on the state and would give these lenders effective control over a significant portion of the state's monthly cash receipts until they are repaid.

Background--Bond Financing in the 2003-04 Budget

Fiscal Recovery Bonds. The 2003-04 Budget Package included AB 7 X1 (Oropeza), which authorizes Fiscal Recovery Bonds (FRBs) in order to finance the estimated 2002-03 year-end budget deficit. These bonds are backed by a temporary half-cent sales and use tax that goes into effect on July 1, 2004. However, the FRBs do not have any general obligation guarantee and do not require voter approval. Furthermore, payments for debt service on the FRBs are subject to annual appropriation. None have been issued to date because the Pacific Legal Foundation has challenged the validity of the FRBs, and the state, in response, is seeking a court validation of the bonds. Issuance of the FRBs will require a final validation action by the courts. It is not clear if or when this will occur. On January 29th, the Director of Finance notified the Legislature that she has certified the 2002-03 year-end deficit amount to have been $8.6 billion. This is $2.1 billion less than the $10.7 billion deficit estimate at the time that the 2003-04 Budget was enacted.

Triple Flip. AB 7 X1 (Oropeza) also reduces the local Bradley-Burns sales and use tax by a half-cent while the temporary state tax is in effect. The net result is that the combined state and local tax rate will not change. AB 1766 (Budget Committee), also enacted as part of the 2003-04 Budget, replaces the temporarily reduced local sales and use tax revenue with property tax revenue shifted to cities and counties from schools. The state, in turn, will make schools whole with increased GF support, as required by Proposition 98. Accordingly, the ultimate cost of repaying the FRBs is borne by the GF.

Pension Obligation Bonds. SB 29 X1 (Committee on Budget and Fiscal Review) authorized the sale of $1.9 billion of POBs to finance the cost of state employer retirement contributions in 2003-04. None of these POBs have been issued to date due to invalidation by the Sacramento Superior Court. The state has appealed the invalidation, but the delay has reduced the maximum potential bond sale to $800 million.

Tobacco Securitization Bonds. The 2003-04 Budget included an estimated $2 billion from an additional sale of tobacco securitization bonds. These bonds are backed by the state's share of annual payments under the Master Settlement Agreement with the major tobacco companies. There is also a backup GF appropriation for repayment of the 2003-04 bonds to provide additional security. These bonds have been sold, and yielded $2.2 billion of 2003-04 GF revenue, which is included in the Governor's Budget.

2004-05 Economic Recovery Bonds

As noted above, most of the bond financing assumed in the 2003-04 budget has not occurred and remains under a legal cloud at this time. The 2004-05 Governor's Budget includes alternative bond financing that is predicated on voter approval of Propositions

57 and 58 at the March 2nd primary election. Proposition 57, the Economic Recovery Bond Act, authorizes the sale of up to $15 billion of state bonds to finance the accumulated General Fund deficit and other deferred General Fund obligations.

Bond Proposal Also Contingent on Approval of Proposition 58. Proposition 57 takes effect only if voters also approve Proposition 58—the California Balanced Budget Act. Proposition 58 amends the state constitution to require enactment of a balanced budget, transfer a portion of future General Fund revenues to establish a Budget Stabilization Account, provide for a mid-year budget adjustment process, and restrict the types of future state debt that may be issued. Proposition 58 also specifies that the ERBs meet the constitutional requirement that any general obligation state debt must be for "single object or work" (typically building construction or land acquisition). Furthermore, Proposition 58 requires that half of the required allocations to the Budget Stabilization Account (which begin in 2006-07) will be used to accelerate repayment of the ERBs up to a cumulative maximum of $5.0 billion.

Major provisions of Proposition 57 and the Economic Recovery Bonds:

- Authorizes the sale of up to $15 billion of ERBs for the purpose of providing financing to the GF for: a) the state's cumulative budget deficit as of June 30, 2004; b) the cost of other GF obligations incurred prior to that date; and, c) issuance costs.

- Provides that the ERBs may be used to refund any FRBs issued under the provisions of AB 7 X1. The $15 billion authorization would be reduced by the amount of any outstanding AB 7 X1 bonds that are not refunded and by the amount of any state 2003-04 POBs that have been sold.

- Provides a high level of investor security. Principal and interest on the ERBs are continuously appropriated from the Fiscal Recovery Fund (FRF) established by AB 7 X1. The FRF receives revenue from the temporary state sales and use tax that is imposed by AB 7 X1 starting July 1, 2004, and future allocations from the Budget Stabilization Account established by Proposition 58. In addition, the ERBs would have a general obligation guarantee that the GF will make debt-service payments if the FRF runs short.

- Reduces both the rate of the temporary state sales and use tax dedicated to the FRF from a half-cent to a quarter-cent and the related temporary reduction in the rate of the local Bradley-Burns sales and use tax. This reduces the annual debt-service cost of the ERBs by half (compared with the FRBs), but increases the time required to repay them.

- Ends the temporary quarter-cent sales and use tax when all of the ERBs and any bonds issued under AB 7 X1 have been repaid, or the FRF contains sufficient revenue to completely pay off all outstanding bonds.

ERBs Will Be Paid off in 9 to 14 Years. Based on estimates by the Legislative Analyst, repayment of the full $15 billion of bonds would occur in about 9 years, assuming all $15 billion of bonds are issued at one time and allocation of the full $5 billion from the Budget Stabilization Account established by Proposition 58 for accelerated debt repayment is achieved (see comment below). Absent any contributions from the Budget Stabilization Account, the bonds would be paid off after about 14 years.

FRBs Remain A Potential Alternative. The administration is pursuing validation of the FRBs as an alternative in the event that Proposition 57 is not successful. However, the FRB authorization is smaller ($8.6 billion, as certified, versus $15 billion), and they would likely require higher interest rates and greater credit enhancement costs than the ERBs because the repayment of the FRBs would not have a general obligation backup and would be subject to annual appropriation.