OFFICE OF THE STATE COMPTROLLER

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Comptroller's Fiscal Update: The Cost of Deficit Financing

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Executive Summary

The proposed State Fiscal Year (SFY) 2010-11 Executive Budget released in January projected a five-year cumulative current services deficit exceeding $60 billion. As a starting point, the proposed Executive Budget closed the SFY 2010-11 projected gap without deficit financing. Since then, various borrowing proposals have been advanced to partially address this projected deficit.

Two of these proposals contemplate the issuance of deficit bonds, backed by Personal Income Tax (PIT) revenues, totaling up to 10 percent of the projected cumulative deficit, or $6.0 billion based on current estimates.[1] A third proposal would close part of the projected deficit with funding from additional bonds backed by tobacco settlement payments. As highlighted in Comptroller DiNapoli's debt impact studies, the amount of debt that the State has already issued for non-capital needs makes up a significant portion of the State's debt burden.[2]

The State currently pays more than $1.1 billion annually in principal and interest for debt issued for non-capital purposes.[3] Proposed new non-capital debt of $6.0 billion paid over ten years would cost the State an additional $725 million to $850 million in annual debt service, or more depending on how the bonds are structured. Over the life of the bonds, taxpayers would spend $7.0 billion to $8.0 billion.[4] More importantly, this borrowing for operating expenses would use more of the State's limited debt capacity, further constraining the State's ability to address its critical infrastructure needs.

The largest driver of growth in State-Funded debt service is attributable to new debt issued for non-capital purposes, including deficit financing and budget relief. Proposals to borrow to fill the current budget gap are inadvisable because they will worsen this problem, and will not improve the State's long-term fiscal health. If bonds were to be repaid over twenty years instead of ten, the annual debt service would be reduced, but the total repaid over the life of

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1 Both proposals would limit the amount of bonds to 10 percent of the projected accumulated five-year deficit and may include costs of issuance. Previous deficit financings, such as the creation of the Tobacco Settlement Financing Corporation, authorized the issuance of bonds in addition to costs of issuance. The Tobacco Settlement Financing Corporation issued $4.6 billion, and, of this amount, $4.2 billion was used to partially fill the General Fund deficit.

2 See *Debt Impact Study*, released by the Office of the State Comptroller. The two most recent reports are available at www.osc.state.ny.us/reports/debt/debtimpact2010.pdf and www.osc.state.ny.us/reports/debt/debtimpactstudy08.pdf.

3 Although a large portion of this non-capital debt was issued in the aftermath of the September 11, 2001 attacks in conjunction with a broader recovery plan, State decisions regarding the use of debt relative to using current tax dollars must be balanced so that when extraordinary circumstances arise, needs can be accommodated.

4 All annual projected costs include principal and interest payments. The annual debt service figures reflect the amount of debt service once all bonds are issued.

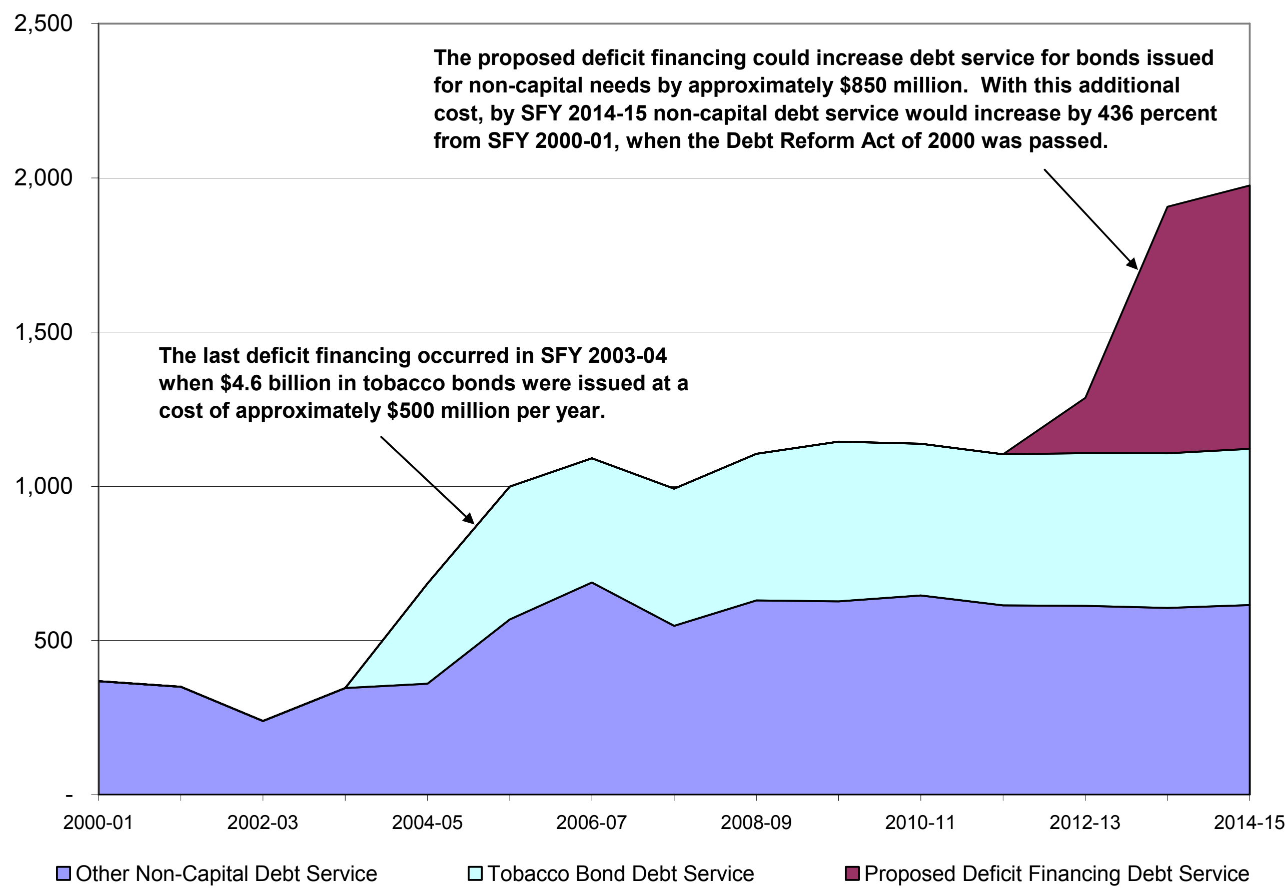
the bonds could approach $9.5 billion. Reliance on short-term patches to close the budget gap may increase the risk of a credit rating downgrade, which could translate into subsequent increases in borrowing costs and limits on the State's flexibility in the future.

Deficit Financing

While all deficit financing proposals increase costs in future years to provide budget relief today, the cost to New Yorkers and the impact on the State's Financial Plan depend on how the bonds are structured. If over a three year period the State issues $6.0 billion in ten-year deficit bonds (including issuance costs) and begins repayment immediately, the full annual cost to the State would be approximately $725 million beginning in SFY 2013-14. This would be an added burden in a year when the deficit is already projected to be more than $20 billion.

If the State follows past practice, however, bonds to pay for issuance costs may be issued in addition to the $6.0 billion in deficit bonds. This decision would provide the State with $6.0 billion in budget relief while requiring the State to repay that amount plus issuance costs with interest. If this is the case, and if principal payments are delayed until all ten-year deficit financing bonds are issued, debt service costs would exceed $850 million annually beginning in SFY 2013-14. Furthermore, these proposals would require a statutory change to notwithstand the Debt Reform Act of 2000, which requires debt to be issued for capital purposes only.

State-Funded Debt Service for Non-Capital Purposes
(in millions of dollars)



The two Personal Income Tax bond proposals being contemplated would involve public authority backdoor borrowing, in which public authorities are used to issue debt for the State's purposes, bypassing voter approval. Currently, only 5.6 percent of State-Funded debt outstanding was approved by the voters.

Additional Tobacco Bonds

A third proposal would authorize the Tobacco Settlement Financing Corporation (TSFC) to issue an additional $700 million, not including costs of issuance. In SFY 2003-04, the State sold its share of Master Settlement Agreement revenues to TSFC in exchange for $4.2 billion in budget relief. Currently, TSFC is required to dedicate the entire amount of Settlement proceeds to debt service on tobacco bonds, which is approximately 23 percent higher (on average) than required for repayment of the debt over 20 years. This has the effect of paying off the debt faster, shortening the expected term of the bonds and lowering the cost of the debt over the life of the bonds.

If the additional $700 million in bonds is paid from current dedicated funds, annual debt service costs would not increase immediately as all tobacco settlement revenues are already dedicated to debt service. However, this mechanism would likely eliminate the accelerated debt repayment structure. This would, in turn, extend the expected term of the bonds by at least two years; thus, it would divert resources originally intended for health care for at least two more years. As a result, the final maturity of the bonds would be closer to the initially required 20 years. The State would lose the benefit of paying off these bonds approximately five years early, as is currently projected. Due to the additional years of debt service, additional costs could exceed $1.0 billion.

Conclusion

In SFY 2009-10, the State paid more than $1.1 billion in debt service on bonds that were issued to finance non-capital needs. This includes debt service for Tobacco Settlement Financing Corporation bonds to finance the General Fund deficit and Sales Tax Asset Receivable Corporation bonds to refinance outstanding New York City Municipal Assistance Corporation (MAC) debt. Several proposals are under consideration that could add over $850 million to the annual non-capital debt service burden in order to partially relieve the current deficit. This would increase annual debt service costs for non-capital purposes by 75 percent.

Furthermore, any deficit financing proposal would be structured to circumvent the Debt Reform Act of 2000, which requires debt to be issued for capital purposes only. This would reverse the State's recent positive trend of paying down debt issued in the past for non-capital purposes.

The State should not borrow to close the budget deficit. Borrowing would do nothing to address the State's fundamental structural imbalance and would add to future projected deficits. Furthermore, it would increase the State's non-capital debt burden, and would not produce any capital asset.[5] However, it would be especially inexcusable if a borrowing plan

[5] See *Debt Impact Study*, released by the Office of the State Comptroller. The report is available at www.osc.state.ny.us/reports/debt/debtimpact2010.pdf.

was enacted and not intertwined with meaningful, comprehensive constitutional and statutory fiscal reforms. Examples of reform include Comptroller DiNapoli's Strategy for Fiscal Reform as well as elements in other reform proposals that move the State Budget to Generally Accepted Accounting Principles (GAAP) and that impose greater fiscal discipline as proposed by Lieutenant Governor Ravitch.[6]

Previous deficit financing actions have failed to effectively address the State's fiscal troubles. Much of the non-capital debt issued remains outstanding, as do the chronic fiscal problems the debt was intended to fix.

State Funded Debt Outstanding for Non-Capital Purposes
(in millions of dollars)

	SFY 2000-01	SFY 2009-10	SFY 2014-15 Current Plan	SFY 2014-15 Tobacco Increase	SFY 2014-15 Deficit Financing
Local Government Assistance Corporation	4,728	3,638	2,499	2,499	2,499
South Mall Refinancing	90	6	-	-	-
Attica	242	165	102	102	102
Prior Year School Aid Claims	-	419	294	294	294
NYC MAC Refinancing	-	2,302	1,997	1,997	1,997
Tobacco Settlement Bonds	-	3,257	1,412	2,112	1,412
Proposed Deficit Financing	-	-	-	-	3,997
Total Non-Capital Debt Outstanding	**5,060**	**9,787**	**6,304**	**7,004**	**10,301**
Total State-Funded Debt Outstanding	**36,958**	**60,400**	**67,041**	**67,741**	**71,038**
Non-Capital % Total	13.69%	16.20%	9.40%	10.34%	14.50%

(1) Note: this assumes immediate repayment of bonds as they are issued. If principal repayment is delayed until all bonds are issued, the amount outstanding in SFY 2014-15 will total approximately $4.3 billion.

[6] See *Ending New York's Chronic Budget Crisis -- Strategy for Fiscal Reform*, released by the Office of the State Comptroller, available at www.osc.state.ny.us/reports/budget/2010/fiscalreform_mar2010.pdf.