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It's not really a debt bond, state says

Kathleen Pender



The state's plan to pay off \$10.7 billion in deficit-reduction bonds has been called a shell game, but that's an insult to shells.

California's plan is more complex and less straightforward than a simple shell game.

"It's the most complicated financing scheme known to man," says Nathan Barankin, a spokesman for the California attorney general's office.

Harold Johnson, an attorney preparing a legal challenge to the plan, calls it a "Rube Goldberg machine" constructed so the bond didn't need voter approval.

The state attorney general's office says it doesn't need voter approval because - get this - the new bonds are not debt in the usual sense.

"The voter approval (requirement) applies to debt. This is not technically a debt bond. It is something else. It is something new, something different. It's like New Coke," says Barankin.

Johnson's response: "Remember what happened to New Coke?"

"This tastes funny. You don't have to be an expert in public finance to say a five-year borrowing constitutes a debt," says Johnson, who works for the Pacific Legal Foundation, which lobbies for tax restraint, property rights and limited government.

The bond's purpose

The bonds will mortar in part of the \$38 billion hole that was left in the state's budget for fiscal 2003-04, which began July 1.

The deficit opened because the state has been spending more than it brings in.

Legislators decided it would be too painful to close the entire gap with tax increases and spending cuts

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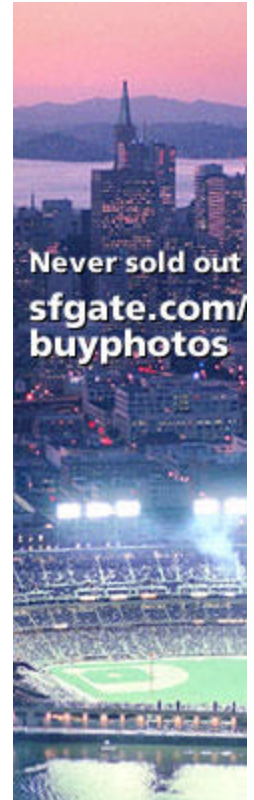
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this year. So they filled part of it with a plan to borrow \$10.7 billion by selling bonds next spring. The bonds will be repaid over five to seven years, starting in fiscal 2004-05.

Normally, bonds are sold to finance capital projects, like schools and prisons, that can't be paid for in one year.

It will cost \$2.3 billion to \$2.5 billion per year to repay the bonds. Although bond proceeds will go into the general fund, the state could not repay the bond from the general fund for legal, political and financial reasons.

Instead, the bonds will be repaid with a three-way shift of revenues dubbed the "triple flip." Here's how it will work:

-- Step 1: The state essentially will repay bond holders with part of the sales tax revenues now going to cities and counties.

Background: The statewide sales tax is 7.25 percent, or 7.25 cents per dollar of taxable sales. (Some cities and counties add taxes for specific purposes. The highest rate is 8.75 percent in the city of Avalon on Catalina Island.)

The state gets 5 cents of the statewide tax, and cities and counties get 1 cent for public safety and other mandated purposes. The remaining 1.25 cents, known as the "Bradley Burns" rate, goes to the city and county where the sale took place.

The state will repeal one-half cent of the Bradley Burns rate. Then it will create a new half-cent sales tax that will go into a fund that can only be used to repay the bonds. Consumers will pay the same rate as before.

-- Step 2

To reimburse cities and counties, the state will reallocate property tax revenues. Cities and counties will get about \$2.4 billion more and schools will get \$2.4 billion less next fiscal year. Each city and county will get the amount it would have if the sales tax had not been repealed. The amount could change in future years.

-- Step 3

The state will reimburse schools with \$2.4 billion from the general fund.

-- Step 4

To fill the hole in the general fund, the state will cut spending - starting next fiscal year.

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Legislators say they have already identified \$2.4 billion in cuts, which include suspending cost-of-living increases in various programs. Even with these cuts, the state still faces a \$7.9 billion budget deficit for 2004-05 that will have to be closed in other ways.

Why the shell game?

If the money ultimately comes from the general fund, why doesn't the state just repay the bonds from the general fund?

To sell the bonds, the state needed to create a "new" revenue dedicated to bond repayment.

"Wall Street said, 'We don't trust you. If you carve out a piece of the general fund, in six or 12 months you can come back and change it. We want a new source of revenue we can count on from year to year,'" says Megan Taylor, a spokeswoman for the League of California Cities.

Gov. Gray Davis proposed creating a new temporary half-cent sales tax (without repealing existing taxes) to pay off the bonds. But Republicans would not stand for a tax increase, and the budget needed a two-thirds majority to pass.

Also, some legislators believed a new sales tax would be subject to Proposition 98, which gives almost half of the general fund to schools. The Davis administration believed the new tax would not be subject to Prop. 98.

Repaying the bonds directly from the general fund - or from the state's share of existing sales tax, which goes into the general fund - would have posed legal challenges.

The constitutional debt limit says the state may not sell a bond issue of more than \$300,000 unless the bonds are for a "single object or work," such as a school or freeway, and the bonds are approved by two-thirds of the Legislature and a majority of voters.

The deficit bonds probably would not meet the "single object or work" requirement, and even if they did, lawmakers were not eager to put them to a vote.

The courts have made an exception to the debt limit for revenue bonds that finance a project, such as a toll bridge, and are repaid solely with money from that project. Revenue bonds do not require voter approval, but the deficit bonds did not meet the requirements for revenue bonds.

Another potential problem: Prop. 98 requires that about 40 percent of general fund revenues go to schools. Some legislators feared the education

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lobby would sue to prevent the bonds' being repaid from the general fund.

The attorney general's office was asked to come up with a bond that would not be subject to the debt limit and would not trigger lawsuits under Prop. 98.

"There are two reasons we worked with the (attorney general) - to avoid Prop. 98 and the debt limit," says David Takashima, chief deputy director with the California Department of Finance.

Barankin, in the attorney general's office, says, "The Legislature asked for a way to structure a bond to cover \$10.7 billion in debt. We advised them how to do it without creating a true debt bond that would require voter approval."

To do so, the attorney general is taking advantage of an exception to the debt limit the courts have made for short-term bonds such as revenue anticipation notes, or RANs.

RANs are a cash management tool. They are sold after a state determines that its revenues for a fiscal year won't come in soon enough to meet expenses for that year. The RANs can be repaid only by tax revenues for that fiscal year, and they are usually repaid within 12 months.

Because RANs are paid off with cash the state has or will have shortly, the courts have decided they are not a debt and are therefore not subject to the constitutional debt limit.

The attorney general's office determined that the deficit bonds could claim the same exemption if the Legislature had to appropriate money annually to repay them.

The deficit bonds will be structured so that each year, at least two-thirds of the Legislature must vote to release money in the sales-tax fund to repay the bonds.

By contrast, general obligation bonds, which are repaid from the general fund, "have a continuous appropriation. The Legislature doesn't have to do an act for the state to owe money," says Molly Arnold, a deputy attorney general.

It's not the triple-flip "that excludes (deficit bonds) from voter approval.

It's the fact that they are only repaid if, in the future, the Legislature creates an appropriation," Arnold says.

What's to stop future lawmakers from raiding the sales-tax fund for purposes other than bond repayment?

One, the statute says the fund can be used only to repay the bonds, unless it grows big enough to repay all the bonds, at which point it could be tapped for other uses.

Two, "failure to make the payments would do something utterly disastrous to the state's credit rating," says Barankin.

Standard & Poor's rates the state's general obligation bonds just two notches above junk.

S&P analyst David Hitchcock says the deficit-bond issue could get a higher rating than the state's general obligation bonds. "It's not necessarily less secure; it could be more secure. We won't know until we see the details," he says.

Arnold says the deficit bonds are neither general obligation nor revenue bonds but "appropriation bonds." This is the first time the state will sell such a product.

New York state started selling similar bonds in 1991 to close a budget deficit. These bonds are subject to annual appropriation and did not receive voter approval, says S&P analyst Robin Prunty.

They are being repaid directly with part of the state's sales tax.

New York didn't need a triple-flip repayment because it doesn't have a requirement like Prop. 98, sources say.

By creating a "new" sales tax that can be used only for bond repayment, the state satisfies Wall Street and prevents the money from entering the general fund, where almost half of it would go to education.

Of course, the ultimate source of the money is the general fund. But funneling it through the triple flip "is more legally defensible for the state," says Arnold.

The education community has not objected to the repayment scheme. On its Web site, the California Teachers Association "applauds" the budget settlement.

The California League of Cities opposes the plan "because we don't like the state coming in and starting to dabble in our revenue sources," says Taylor. The league fears the state could renege on its promise to give cities an extra \$2.4 billion a year.

"There is a strong commitment by the people who voted on this to pay it back, but some of those people won't be here in five years," Taylor says.

The California State Association of Counties did not oppose the sales tax swap.

Jean Ross, executive director of the nonpartisan California Budget Project, says the bond repayment scheme "is a shell game, and nobody disagrees with that."

If the bonds are going to be repaid from existing resources, she doesn't object to the triple flip.

"The basic policy question is: Do you believe the state should borrow \$10.7 billion without having a new revenue source? I think they should have raised revenues to pay bonds," Ross says.

Takashima, of the state Finance Department, says he helped design the deficit bonds reluctantly.

"We tried to get people to do some of the hard work, and they said no. The Legislature said no new taxes."

The deficit bond "is a workout plan," he adds. "Next year, there has to be a serious resolution on a lot of issues that impact California. The revenue streams we have are very unstable."

Takashima promises, "We're not going to come back and do a deficit financing again. The administration and the Legislature agree we're doing this once."

How the state will sell and repay deficit bonds in four steps

To reduce a deficit in this year's budget, the state plans to borrow \$10.7 billion by selling bonds.

Although bond proceeds will go into the general fund, the state can't repay the bonds from the general fund for political, legal and financial reasons. Instead, the state will repay the bonds over five to seven years with a three-way shift of revenues. This shows how it will work. .

1. BOND ISSUE

The state will borrow \$10.7 billion by selling bonds to investors next spring. The proceeds will go into the state's general fund to close the 2003-04 budget deficit. The bonds will be repaid over five to seven years, starting in fiscal 2004-05.

2. SALES TAX SHIFT

The state will repay bondholders, about \$2.4 billion a year, with a "new" half-cent sales tax. To avoid raising taxes, the state will repeal a half-cent of the sales tax that had been going to cities and counties.

3. PROPERTY TAX SHIFT

To make up for lost sales tax revenues, the state

will give cities and counties \$2.4 billion more in property taxes, and schools \$2.4 billion less.

4. GENERAL FUND SHIFT

To make up for lost property tax revenues, the state will reimburse schools with \$2.5 billion a year from the general fund. The resulting \$2.5 billion general fund deficit will be made up with spending cuts, starting in fiscal 2004-05.

Source: Chronicle research

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