

Opportunities and Risks For Municipal Bond Investors

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Eric Leve, CFA
Senior Vice President, Global Fixed Income

Executive Summary: California's budget crisis is unprecedented in magnitude but will likely be resolved as California's economy recovers. Fiscal restraint in this year's budget should help alleviate the crisis, although structural problems will remain. Despite the risks, the current pricing of the California municipal bond market is creating opportunities for high net worth investors seeking a tax-efficient complement to their equity portfolios.

Introduction

In 1994, on the heels of the worst recession in a decade, California's accumulated budget deficit ballooned to \$3.85 billion. Along with this deficit, structural budgetary constraints and overly optimistic expectations prompted Moody's Investor Services (Moody's) to downgrade California's general obligation debt to a rating of A1.¹ This was the lowest credit rating California had held since it came out of the Great Depression. As the 2003 – 2004 budget process begins, California is faced with an expected deficit of \$34.6 billion. Similar budgetary handcuffs to 1994's make Governor Gray Davis's responsibility to balance this budget more difficult than at any other time since the Great Depression. Recently, the state's financial condition pushed Moody's to again downgrade California's credit rating to the unprecedented level of A2. This paper will try to make sense of the fiscal situation and the budget process. We will explain the impact of the budget crisis on the state itself, its taxpayers and residents, and on those who invest in its municipal debt.

Economic Backdrop

California's economic situation has faltered more spectacularly and more dramatically than that of the country as a whole. Anecdotally, individuals have perceived and heard about weakness in home pricing and the local economy's dependence on the technology sector. But how has that translated into the largest state surplus in California's history becoming the largest state deficit in the Union's history?² Much of the answer lies in the hubris of the bull market and the fiscal structures built up during it.

The bottom line for state revenues is simple; in good times they rise and in bad times they fall. During the last expansion, from the 1993-1994 fiscal year through the 2000-2001 peak, state General Fund revenue almost doubled, rising 10.2% annually. By 2000-2001, revenues had hit \$75.7 billion. Of course, as revenues grew, so did spending. And, while spending didn't quite keep pace with revenues, its growth was sizable: from \$47.3 billion at the beginning of the period to \$80.1 billion at the end of the period.

¹ See table on page 4 for explanation of ratings definitions.

² At \$12.8 billion, the surplus in June of 2000 was larger than the entire budgets of 47 other states.

We are now seeing that process in reverse. State revenues are down to an expected \$65.8 billion for this fiscal year and expenses may total \$62.7 billion.³ Spending mandated during the good times has quickly been ratcheted down. Already, outlays have returned to the levels of the 1998-1999 budget.

Several structural problems have heightened the fiscal impact of the economic downturn. California, compared with other states, is one of extremes. We have both a larger proportion of our citizenry living below the poverty line,⁴ as well as more at the upper reaches of the income spectrum. Together, this creates a situation of greater responsibility for the state government, supported largely by tax receipts that are highly dependent on the state of the overall economy. An overwhelming proportion of the state's income tax revenue comes from its wealthiest citizenry; in 2000, the top 11% of

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state taxpayers – those earning more than \$100,000 – paid 80% of the personal income tax.

Unfortunately, the income of the state's wealthiest taxpayers is greatly affected by economic cycles. In no period has that been clearer than in the past three years. In 2000, California realized about \$17.6 billion in

revenue from income taxes on capital gains and stock options. This represented a seven-fold increase since 1994. In the past

³ Here we are including only General Fund revenues and outlays. When discussing the state's deficit, legislators include additional special and other funds of about \$20 - \$25 billion.

⁴ This is a fairly recent phenomenon. As recently as 1989, the percentage of California's population living below the poverty line was almost equal the national average of 12.8%. As of year-end 2000, California's percentage had risen slightly to 12.9% while poverty in the nation as a whole had declined to 11.3% of the populace. A common explanation for this is the extent of immigration California faces compared with the rest of the country.

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three years, that amount has fallen more than two-thirds and thus makes up the overwhelmingly largest component of California's reduced tax revenue.

Making this income tax shortfall all the more acute is California's increasing reliance on this revenue.

Personal income tax revenues accounted for only 18% of General Fund revenues 40 years ago, but now make up 48%. One of the largest components of this shift in the state's revenue occurred in 1978, with the passage of Proposition 13. The dramatic decrease in the steady revenue generated by property taxes left the state with a more volatile revenue stream determined by income tax receipts.⁵

In addition, the state's sales tax collections have failed to keep pace with the evolution of the nation's economy. The move to a more service-based economy has cost local economies as much as 40% of their revenue compared with the more goods-based economy of previous generations. More recently, the advent of e-commerce has created further leakage in states' ability to tax commerce.

Increasing Budget Strain

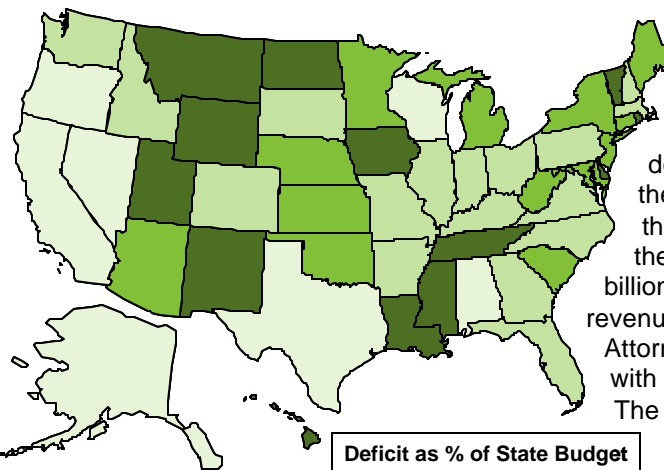
The process of creating California's annual budget is complex and has become more so over the past 25 years. Beginning with Proposition 13 in 1978, voters have imposed an increasing number of revenue restrictions and spending mandates upon the state. Many of these well-intentioned constraints were approved during strong economic times when they seemed like a luxury the economy could easily shoulder. Unfortunately, the handcuffs imposed by some of these programs have exacerbated the impact of the economy's downturn on state finances.

⁵ About 12% of property tax revenue goes to the state level. The other major effect of Proposition 13 was increased expenses in the form of support of local programs for which sufficient local revenue no longer existed.

Monies that were previously part of the state's General Fund became dedicated for specific uses. In 1998, Proposition 98 required that 40% of the General Fund be dedicated to K-14 education. More recently, Proposition 42 redirected all state gasoline sales taxes to the state's Traffic Congestion Relief Plan.

1998's rollback of the Vehicle License Fee (VLF) has imposed additional constraints on the state budget. Because of the strong economic environment when the rollback was passed, the state offered to continue funding local programs that previously had been covered by VLF revenues. Municipalities were insulated from the revenue decrease by a "fill back" provision that returned funds to local governments. The cost to the state's coffers

amounted to about \$3.6 billion last year.



Source: Center on Budget and Policy Priorities

governor must use his line-item veto to rebalance that budget before it becomes official.

California, uniquely among the states, allows deficits from previous years to be carried forward. This mostly results from the state's inability to adjust mid-year to changes in the broader economy.⁷ As an example, 2001-2002 produced a huge revenue shortfall⁸ due to the dramatic decrease in stock market related revenue – a deficit the state continues to face and that is included in Governor Davis's current \$34.6 billion estimate.

Last year's budget saw several stop gap solutions which helped soften the blow from the economic downturn. Unfortunately, these can't be replicated this year. In 2002-2003, the state "securitized" \$4.5 billion in future expected revenue from the states' Attorneys General settlement with the tobacco companies. The money raised in this bond offering did not go to support the health programs envisioned in the tobacco settlement but instead to bridge

last year's overall budget gap. Also late last year, California floated \$11.9 billion in debt to cover the costs of power purchases from the state's energy crisis that began in late 2000.

Budget Process

The actual budget process in California is more complicated than most states, not just because of sheer size, but also due to idiosyncratic features that can lead to political and financial distress. Like most states, California's governor is required to submit a balanced budget proposal to the legislature. The legislature, on the other hand, is not required to send that budget back to the governor in balance, but what they do decide upon must be ratified by two-thirds of the legislature.⁶ Finally, the

A Broader Perspective

Of course, California is not alone in its fiscal crisis. We are among 23 states that expect to shrink their state budgets for the upcoming fiscal year. Sixteen states expect budget deficits that exceed 15% of their budget. Leading this list is Alaska, whose expected deficit amounts

⁶ Only Arkansas, Nebraska, Rhode Island and, to some extent, Illinois have similar requirements.

⁷ The governor did have this power prior to 1983.

⁸ This is estimated at \$8 to \$10 billion.

to almost 40% of its budget. Not far behind is California, at 32.5%, the only other state whose deficit exceeds the 30% threshold. In dollar terms, of course, California has no equal. Its \$34.6 billion shortfall accounts for one-third of the states' total 2003-2004 expected deficit of \$106 billion.

As much as one-quarter (about \$25 billion) of the \$106 billion is estimated to be a result of unfunded mandates imposed by the federal government. But even with these deficits, the reality remains that state budgets are shrinking to close their budget gaps. This spending slowdown (along with tax increases⁹) can be considered an offset to the stimulus being proposed by President Bush's tax proposal. A rough estimate is that, of the 2.5% tailwind provided by federal policy, state

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budget restraint takes away more than a quarter, or 0.7%. And clearly, the effects don't end there. Cities and counties are feeling the pinch due to states' underfunding of *their* mandated programs. Steve

Peace, California's new director of finance, cautions that some cities and counties may face lower credit ratings due to the reduced funding.

The accompanying table details the roller coaster ride of the credit rating of California's "general obligation debt" (that is

⁹ For the period from 1994 to 2001, cumulative state tax cuts totaled \$37.7 billion. 2002 was the first year since 1994 that the states (cumulatively) raised taxes. That hike was about \$6.7 billion, but the upcoming 2003 – 2004 budget cycle will likely more than offset the previous seven years of reduced taxes.

backed by the state's full taxing power) during the past sixty years:

Late last year, the state's rating was cut to a level last seen during the aftermath of the early 1990s recession. In July 1994, when the state last had an A1 rating, the

accumulated deficit was only \$3.85 billion, but the onus of the newly passed Proposition 98 made credit rating agencies unsure of the state's ability to pay all of its commitments. In mid-February of this year, the rating was lowered another notch to A2, its lowest ever. California now shares the nation's lowest credit rating with New York and Louisiana. Moreover, the state's credit rating could decline further; an A3 rating is not out of the question before the situation turns around. This of course means

higher interest costs to compensate bond buyers for the increased risk. Current bondholders also face the risk that those higher interest rates would lead to lower prices on the bonds they currently hold.

Davis's Plan

Governor Davis's plan to balance the budget spreads the burden through a range of solutions. It relies on program cuts for about 40% of the savings. About one-fourth is related to increased taxes, and the other one-third is derived from a combination of shifts between the local and state authorities and borrowing to bridge gaps.

In the area of tax increases, the governor proposes raising the top marginal tax rates for the state's wealthiest taxpayers from 9% to 10% and 11%. The proceeds from this increase would go directly to local authorities that would assume responsibility for Medi-Cal benefits, long-term care, in-home support services and childcare. Additionally, the proceeds from a 1%

Moody's Rating for California General Obligation Debt, 1938-2003		
Date	Rating	Investment Grade Debt Scale
2/03	A2	Aaa Top Grade
11/01	A1	Aa1
5/01	Aa3	Aa2
9/00	Aa2	Aa3
10/98	Aa3	A1
7/94	A1	A2
7/92	Aa	A3
2/92	Aa1	Baa1
10/89	Aaa	Baa2
4/80	Aa	Baa3 Mid Grade
9/72	Aaa	Note: Prior to 1989, Moody's did not include the numerical qualifiers.
11/40	Aa	
1/38	A	

Source: California, State Treasurer's Office; Moody's

increase in the sales tax would go directly to local programs. This realignment would shift \$8.2 billion of funding responsibilities from the state to the county level. In a similar shift, Gray Davis has proposed ending the “fill-back” provision on vehicle license fees. The impact on local economies could be dire, as these “fill-back” funds account for as much as 25% of some smaller communities’ revenues.¹⁰

One of the strategies proposed by Governor Davis to plug about \$1.5 billion of this year’s deficit is the sale of “pension obligation bonds.” Instead of paying its contribution to its employees’ pension plan, Calpers, the state will borrow the funds from bond buyers, relying on the assumption that the returns achieved in the fund will exceed the borrowing cost and thereby lessen the need for future contributions. About \$10 billion of similar bonds have been issued nationally in the past 15 years; their success obviously depends on the strength of future market returns.

Before we turn to the investment implications of the state’s budget crisis, let’s review our observations and make some conclusions. Yes, California has the highest deficit in its history measured both in dollars and as a percentage of the state’s budget. And yes, the state’s budgetary process is hamstrung by voter-imposed initiatives and its own rules. And yes, the windfall from the stock market gains the state enjoyed in the late 1990s is unlikely to return soon. But California remains at the forefront in its ability to draw a talented and dynamic populace. It enjoyed the greatest benefits of the technology boom and it is feeling the effects of the recession hardest. California will likely be among the winners when the economy strengthens.

Of the \$34.6 billion deficit, at least a third can be attributed to expected capital gains

¹⁰ As of this writing, the Assembly has responded with a bill that reverses the VLF rollback and returns the VLF paid by consumers to its original level. Republicans in both houses are hoping to put such a tax increase before the voters before it becomes law.

revenue that never materialized. Much of the rest has resulted from spending programs and constraints that have not caught up with the state’s economic situation. Gray Davis’s plan is tough medicine and so are the budgets being proposed in many other states. But since states, unlike the federal government, cannot print money, the only solution is fiscal belt tightening. And even though this restraint undoes some of the federal government’s expansionary policy, it is probably the quickest path back to the black.

Risks For Investors

When we talk of lower credit ratings we talk about higher interest rates as a result, but the ratings, in the end, are supposed to reflect increased default risk. Is this something that municipal bond investors need to be concerned about? The short answer, we believe, is generally no. Although history is studded with a few well-known and high-profile defaults (Washington Power, New York City, Orange County), in reality, municipal default is exceedingly rare. Over the past twenty years, cumulative municipal bond default has averaged less than 1%. This number is, in fact, a vast overestimate of most investors’ experience, since it is biased by the events mentioned above and by factors that are unlikely to be repeated soon. First, increased default risk was created by the high absolute level of interest rates on debt issued near the beginning of this period by municipalities that didn’t manage that risk well. Also, prior to the Tax Reform Act of 1986, a broader and lower quality array of borrowers was freer to tap the municipal market. Without these factors, default experience was almost negligible. In fact, not a single state general obligation borrowing has defaulted since the Great Depression.

As we’ve seen, California has used debt extensively to bridge gaps in the past few years (tobacco, pension, utility crisis) and at the same time, taken on increasing general debt. But we are not alone. Recent

estimates of total outstanding municipal debt approach \$1.5 trillion. Of this, California appears to account for \$178 billion. Most of this borrowing occurs at the city and county level; in California, \$121 billion is accounted at the local level. Of the \$56 billion at the state level, only about \$22 billion is backed by its full faith and credit.¹¹ And even though California has more debt by far than any other state, on a per capita basis and relative to the size of the economy it is actually well below the national median. But the burden of this debt is not immaterial; interest costs amount to more than \$9 billion on an annual basis.

As mentioned earlier, tax revenue growth is sensitive to the strength of the underlying economy and growth in the tax base. When better times return, tax revenues will go up and much of this problem will be ameliorated. California is still one of the largest, most diversified, innovative and robust economies in the world. The biggest risk is pursuing policies that are counterproductive to near term growth.

Another risk factor that holders of municipal debt face comes from President Bush's dividend proposal. According to some analysts, the president's proposal to eliminate the double taxation of dividends would put upward pressure on other yields that compete with dividend-paying stocks for investors' dollars. California Treasurer Phil Angelides has said that Bush's proposal could raise municipal yields as much as 50 basis points (0.5%), costing California as much as \$17.2 billion over 10 years. This is probably a worst-case scenario and requires a number of assumptions about the economy, budget policy, investor preferences and the current

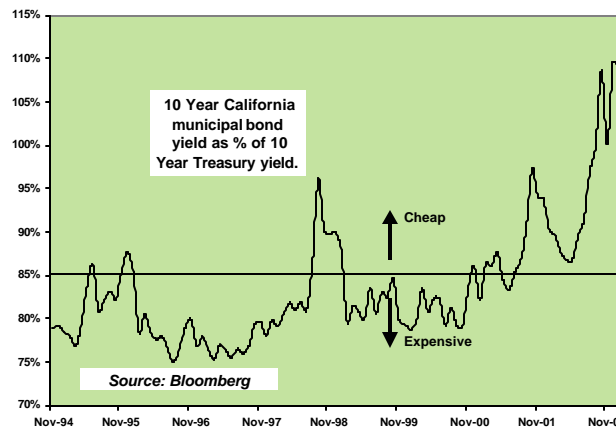
¹¹ This is the portion Moody's recently downgraded. Most of the state's other debt is backed by revenue from specific projects.

relative attractiveness of other assets. Investors probably wouldn't view stocks and bonds as direct replacements for one another even if they both paid tax-free income. The only municipal bonds that may be in direct competition with stocks would be the longest maturity bonds that exhibit a similar amount of price volatility. With that in mind, the greatest increase in rates might occur at these longer maturities. Finally, while the dividend yield on the S&P 500 is expected to rise, at the current level of 2%, it is far behind the 4.3% available on 10-year municipal debt.

Opportunities For Investors

Clearly, the confusion caused by policy, economics and global politics has created some opportunities for investors. Yields on municipal debt in general have risen dramatically compared to yields on risk-free Treasury debt, making the tax-exempt yield on the municipal debt more attractive than it has been in a long time. In addition to that, California debt has been

cheapening, offering more yield than municipal bonds as a whole. This process has reversed a decade-long trend of California debt becoming more expensive, or having lower yields, than the rest of the nation. The turning point in this process occurred two years ago, when



the utility crisis forced the state to purchase energy on behalf of local utilities. As economic prospects dimmed, this process accelerated. Today the state's debt offers yields that are almost 0.5% more than typical AAA-rated bonds (compared to 0.25% more just two years ago). For investors willing to bear volatility in bond pricing, this probably represents value. Within the municipal market, investors' preferences may subtly shift away from general obligation bonds backed by uncertain tax receipts to more revenue-backed debt (e.g. water, sewer). This shift

would probably occur on general obligation debt issued at the state level, but even more acutely, at the local level.

In light of the macroeconomics – interest rates are historically low now and will eventually head higher in the next upturn – owning callable versus non-callable debt could be advantageous. During the bull market for bonds we've experienced over the past twenty years, non-callable debt has been preferable, since it allowed investors to enjoy appreciation as yields fell without the risk of having their debt "called away." But once we see the bottom of the current interest rate cycle, the extra yield offered on callable debt will begin to look desirable as the likelihood of losing that bond to an eventual call is lessened.

Another interesting opportunity in the municipal bond arena is one that looked rather stodgy a couple of years ago: closed-end funds. These funds, unlike traditional open-end mutual funds, issue only a set number of shares. The shares may trade at a premium or at a discount to the value of the underlying bonds. Given some of the discounts currently available, the effective tax-free income distributed from these vehicles can look very attractive.

The risk to municipal bonds from Bush's dividend proposal has been discussed above. Within the fixed-income universe, municipal debt will remain the only source for tax-free income, preserving its status vis-à-vis treasury, agency and corporate debt. It is unlikely a relative shift would occur among investment *within* these areas. On the other hand, the competition of tax-free income from the equity market could result in some movement of assets *between* these areas, particularly when the economy improves. For those seeking secure income, though, the equity market provides an imperfect substitute. This alone limits the volume of flow likely between these asset areas. And realistically, at this point, the

dividend proposal has a long way to go before becoming law.

Finally, the pressures brought on by the events of the past few years have led California municipal debt to underperform municipal debt from other areas. Given the yield advantage California currently enjoys over other states that will likely turn around in the future. The timing of that turnaround is probably dependent on the state of the national economy.

Conclusion

The current budget crisis, while mind-boggling in absolute terms, is very manageable for a state of California's wealth and resilience. Governor Davis has put forth an aggressive plan that is designed to balance the budget without aggravating the economic downturn. Fortunately, California, like any large economic entity, can bear the weight of ongoing deficits. The debt the state has taken on may have helped to stabilize employment during the economic downturn and, fortunately, it has been taken on at a time of relatively low interest rates.

As it has in the past, the state's credit rating will rise in good economic times and fall during and after recessions. We are likely nearing the trough for the current ratings cycle. Even at the state's current A2 rating, California bonds continue to attract investors. Yes, the state has had to pay them a bit more, but that has come on top of historically low interest rates, making the financing still seem cheap to city, county and state treasurers.

Municipal bonds should continue to play a core role in the portfolio of any high net worth investor. Risks surrounding the debt have undoubtedly risen as the economy has faltered, but municipal bonds continue to provide the best and most tax-efficient complement to an equity portfolio.

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Bailard, Biehl and Kaiser
950 Tower Lane, Suite 1900
Foster City, CA 94404-2131
650.571.5800

www.bailard.com