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FRBSF Weekly Letter

California Bonds—After Prop. 13

California's voters went to the polls last week and gave Proposition 4—the spending-limitation initiative—an even more resounding victory than they gave Proposition 13 a year ago. But these draconian citizens' initiatives sometimes have unexpected side effects. As an example, Proposition 13 has had some strange financial consequences—aside of course from such highly visible effects as a $7-billion reduction in property taxes and a $4½-billion transfer of funds from the state to local governments in its first year of operation.

Proposition 13 has raised the cost of many kinds of municipal debt. Even more important, it has eliminated the option of newly-approved general-obligation bonds of local governments, school districts, and other special districts. Restoration of such capital-financing capabilities would require another constitutional amendment, essentially amending Proposition 13. Meanwhile, any local governments and special districts wishing to use debt financing are being forced to shift to higher-cost bonds. The amendment particularly affected tax allocation debt issued by redevelopment agencies, requiring subsequent legislative attempts to protect this outstanding debt from default.

Under Proposition 13, 1978-79 taxes on all property have been rolled back to 1 percent of 1975-76 market value. Tax rates subsequently are held at the 1-percent ceiling, while assessed values may rise no more than the annual percentage increase in the consumer price index or 2 percent per year, whichever is less. (However, properties sold, traded, or newly constructed after 1975-76 may be reassessed at current market values.) The amendment also attempts to prevent other taxes from rising to offset the lost property-tax revenues. It requires that state-tax increases be passed by a two-thirds vote of all members of the legislature, and requires that local (non-property) tax increases gain the approval of two-thirds of all "qualified electors" in the affected municipality.

Proposition 13 specifically exempts tax increases needed to service *prior voter-approved debt*. Thus, payments on debt *approved by voters* prior to the effective date of Proposition 13 (July 1, 1978) are not subject to the specific tax constraints placed on property. But payments on all new debt approved after that date, and on all prior debt not voter-approved, are constrained by the tax-limitation provisions of the amendment.

Types of debt

To understand the amendment's consequences, we should consider some of the structural aspects of the debt market. State and local government debt is issued not only by states, cities, and counties, but also by special districts (such as school, utility, or special-assessment districts) and redevelopment agencies.

The default risk of municipal bonds depends on their security—that is, the legal and economic constraints affecting the cash flow available for debt service and retirement. At one extreme, a general-obligation bond is secured by the overall cash flow of the issuing entity. By law such bonds must be secured by unlimited taxing authority, and their security depends on the agency's power to tax, as well as its fiscal solvency and the strength of its tax base. At the other extreme, a pure revenue bond is secured solely by the revenue generated by the financial project. Hence its security comes from the anticipated cash flow of the project, not that of the issuing entity.

But other kinds of debt also must be considered. Often a municipality creates an artificial distinction between revenues

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of a project and general revenues, thereby creating a "hybrid" revenue bond payable out of a specific revenue but backed secondarily by the issuing entity's general cash flow. An extreme example of this concept is a lease-revenue bond of a "leaseback" corporation that issues its own debt, builds a facility (such as a stadium), leases the facility to the municipality, and then uses the lease proceeds to pay off the bonds. Again, there are tax-allocation bonds issued by redevelopment agencies, which are secured by the incremental property-tax revenues resulting from increased land values in redevelopment projects. Because of the restrictions surrounding these and similar types of bonds, they normally pay yields in excess of those on general-obligation securities.

State debt costs
Proposition 13 apparently has boosted the cost of California's debt financing. The amendment does not fix a strict ceiling on state tax rates, but it does require a two-thirds vote of the entire legislature (not just those voting) to increase statutory rates. This restriction alone should not threaten the state's debt, although it conceivably could make it impossible to raise taxes if default were imminent. Since Proposition 13's passage, however, the state has channeled well over $4 billion per year in "bail-out" funds to local governments and special districts, and has also passed two temporary income-tax cuts. It has thus drawn down most of its budget surplus.

Despite the thinner budget cushion, fiscal restraint has enabled the state to retain its high rating—Aaa Moody's and AAA Standard and Poor's—on general-obligation debt. However, the cost of state general-obligation debt has increased by an average of 25 basis points (.25 percentage points), after adjusting for changes in the general level of municipal-bond rates. Furthermore, compared with 1977—the last year prior to Proposition 13—the state has relied more heavily on revenue-bond financing tied to specific facilities, with rates averaging roughly 80 basis points over the general-obligation rate. Thus, Proposition 13 has meant an increased cost of state debt, although the future trend could go in either direction depending on the state's overall fiscal management.

Local debt costs
Proposition 13 has exerted an even stronger impact on local debt financing. Traditionally, the power of local governments to tax has been interpreted as the power to increase property-tax levies, their discretionary source of income. For that reason, Proposition 13's tax-rate ceiling has been considered tantamount to removal of local government's legal authorization to issue "new" general-obligation debt—debt for which voter approval was obtained after June 30, 1978.

With that avenue closed, local governments and other entities will have to finance construction through current revenues, state assistance, or debt other than general-obligation bonds. Revenue bonds have proven to be a viable instrument in those cases where a facility can generate enough to pay the debt service, but otherwise, governments have had to rely on other forms of higher-cost financing such as lease-revenue bonds.

In this situation, the prognosis is for reduced capital expenditures and increased costs of debt financing. School districts, already blocked from issuing new general-obligation bonds, will be unable to issue pure revenue bonds because they do not normally construct self-supporting facilities—nor will they be able to impose additional property taxes to finance lease-revenue bonds. Thus, legislation has been enacted to provide for state support of schools' new capital expenditures. Meanwhile, despite the lack of issues of "new" general-obligation debt, local governments have been in no rush to issue large amounts of revenue or lease-revenue bonds in its place—and of those bonds issued, the average rise in risk premiun has been approximately 40 to 45 basis points.

Redevelopment agencies have suffered the most, because of their primary reliance on property-tax receipts. Anticipating the problem, agencies rushed to issue this type of debt before they could be caught by the passage of Proposition 13. In the eight months prior to the election, they brought 45 issues of tax-allocation bonds to market, totalling $420 million, but issued no bonds at all in the eight months following the election. In the pre-election bulge, interest costs increased more than 250 basis points (to the legal rate ceiling) and some issues never received bids. Because of the turmoil created by Proposition 13, many observers predicted default for over half of existing tax-allocation debt—but that fate was averted through the passage of new state legislation.

New directions

The authors of Proposition 13 may have had debt limitation as well as tax limitation in mind. But there are less disruptive ways of limiting debt than restricting the sources of funds needed for its repayment. By taking the latter route, Proposition 13 has effectively eliminated local general-obligation debt entirely and has constrained other debt financing only indirectly, and in the process has made it more risky and costly. Furthermore, the amendment has impaired the security and hence the market value of outstanding (pre-Proposition 13) debt that was issued without voter approval.

California's legislators have acted since the passage of Proposition 13 to deal with this problem—and indeed, to restructure the entire financial environment of California government. The two annual "bail-out" bills represent the most important of such efforts. These bills have not only transferred funds from the state to local governments, but also have redistributed tax revenues among local governments and special districts.

Meanwhile, new legislation has begun to clarify the situation resulting from Proposition 13's dramatic threat to the tax-allocation debt of redevelopment agencies. In April 1979, the governor signed Senate Bill 55, which enables redevelopment agencies to levy "special assessments" within their project boundaries up to the amount needed to pay off pre-existing tax-allocation bonds. The bill may be criticized for stretching the legal use of special assessments, but it has allowed redevelopment agencies to reinstitute higher property-tax rates where needed to avoid default on outstanding debt.

Separate legislation has been enacted to deal with the fact that Proposition 13 left school districts with no economic means of financing large capital expenditures. In July 1979, the Governor signed Assembly Bill 8 (the Emergency School Classroom Law) to provide special state funds for portable classrooms and, over a longer period, to reallocate certain taxes toward school-district capital projects. The bill also allows a school district to impose a "development lien" (special assessment) on all property within the territory directly benefitted by the school. Because such a lien requires consent of property owners, it probably will be practicable only where an area is being newly developed, in which case liens would be attached to homes prior to sale.

On balance, most capital expenditures for schools will probably have to be state-funded in future years.

These legislative developments have corrected some of the most pressing capital-market problems resulting from Proposition 13, but clearly they have not solved the basic long-term problem of funding capital projects in a low-cost and efficient manner. In this connection, it is noteworthy that the newly-passed Proposition 4 (the Gann Amendment) has been carefully designed to avoid the capital-market problems of its predecessor. However, it does not solve the problems created by Proposition 13. Another state constitutional amendment will be required to enable local governments, school districts, and other special districts to issue new general-obligation debt. Until that time, local capital spending probably will be limited to whatever can be financed through the state (thereby causing a further loss of local autonomy), through pure revenue bonds where feasible, or through more costly forms of debt financing.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 10/31/79	Change from 10/24/79	Change from year ago @ Dollar	Percent
Loans (gross, adjusted) and investments*	135,109	+ 660	+ 17,739	+ 15.11
Loans (gross, adjusted) — total#	112,063	+ 776	+ 16,929	+ 17.79
Commercial and industrial	31,390	+ 394	+ 3,455	+ 12.37
Real estate	41,719	+ 194	+ 8,677	+ 26.26
Loans to individuals	23,846	+ 268	NA	NA
Securities loans	1,705	− 45	NA	NA
U.S. Treasury securities*	7,396	− 171	− 759	− 9.30
Other securities*	15,650	+ 55	+ 1,569	+ 11.14
Demand deposits — total#	45,179	+ 2,158	+ 2,249	+ 5.24
Demand deposits — adjusted	31,222	+ 188	+ 574	+ 1.87
Savings deposits — total	29,264	− 573	− 1,211	− 3.97
Time deposits — total#	56,638	+ 800	+ 8,432	+ 17.49
Individuals, part. & corp.	48,333	+ 820	+ 9,544	+ 24.60
(Large negotiable CD's)	20,737	− 185	+ 1,781	+ 9.40

Weekly Averages of Daily Figures	Week ended 10/31/79	Week ended 10/24/79	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	+ 114	− 1	− 1
Borrowings	125	179	44
Net free reserves (+)/Net borrowed(−)	− 11	− 180	− 45
Federal Funds — Seven Large Banks			
Net interbank transactions [Purchases (+)/Sales (−)]	− 138	+ 669	− 218
Net, U.S. Securities dealer transactions [Loans (+)/Borrowings (−)]	+ 185	− 21	− 608

* Excludes trading account securities.
# Includes items not shown separately.
@ **Historical data are not strictly comparable due to changes in the reporting panel; however, adjustments have been applied to 1978 data to remove as much as possible the effects of the changes in coverage. In addition, for some items, historical data are not available due to definitional changes.**

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