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No. 02-04 LRB Notes August 5, 2002

GENERAL OBLIGATION BONDS

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Every year, bills are introduced with the intent of authorizing the issuance of general obligation (GO) bonds and making appropriations for various capital improvement projects. This memo will attempt to provide some basic information on what GO bonds are, why they are introduced in the Legislature, and what is the role of the Legislature in dealing with these requests.

Q1: What is a bond? What is a General Obligation Bond?

A1: A bond is a written promise to pay a specified sum of money (*i.e.*, the principal amount) at a specified time in the future (*i.e.*, the maturity date) and to periodically pay interest at a specified rate (*i.e.*, the coupon rate), in return for a loan.

A state general obligation bond is a bond that is backed by the "full faith and credit" of the State. In other words, the State is pledging its full taxing powers to guarantee the prompt payment of the principal and interest on the GO bonds, as they become due. By comparison, a revenue bond is backed solely by the income received by the revenue-producing enterprise (*e.g.*, the airports system) being financed by the revenue bonds. Unlike GO bonds, revenue bonds are not backed by the full faith and credit of the State. All other things being equal, GO bonds are more secure (*i.e.*, safer) investments than revenue bonds. Since interest rates increase as the risk of nonpayment increases, GO bonds command (*i.e.*, allow the State to borrow at) lower interest rates than revenue bonds.

Q2: What are GO Bonds used for?

A2: General obligation bonds are *usually* issued to pay for capital improvement projects such as public buildings and schools. Capital improvement costs include plans, land acquisition, design, and construction, as well as the cost of initial, built-in equipment and necessary, common use furnishings. Capital improvement projects are generally intended for long-term use or ownership and are relatively permanent in nature. *Generally*, capital improvement costs do not include operating, repair, or maintenance costs, nor do they include the cost of new or replacement equipment and furnishings for existing facilities.

Major renovations, including additions or improvements to, or the conversion of, existing facilities, qualify as capital improvement projects. Repair and maintenance work that does not involve the conversion of a facility from one type of use to another usually does not qualify as a capital improvement project.

Q3: Why are bonds used?

A3: The State issues GO bonds in order to raise money to accomplish and carry out various governmental purposes. The financing of capital improvement projects with borrowed moneys--a method labeled "pay-as-you-use"--allows present and future generations of facility users to share in the cost of building a facility (*e.g.*, a prison or library) that is used over a long period of time. This spreads out the cost of the facility among all users, rather than requiring one generation of users to pay all costs for a facility that is used for more than one generation. If these projects are financed with current revenues (*i.e.*, "cash-on-hand")--a method labeled "pay-as-you-go"--then future generations of facility users would not share in the cost of such facilities.

The use of GO bonds to finance capital improvement projects can be the difference between building a facility "now" with borrowed moneys and building a facility "later" with current revenues.

Q4: What is the role of the Legislature concerning GO bonds?

A4: Article VII, section 12 of the Hawaii Constitution requires the Legislature, by a majority vote of the members to which each house is entitled, to authorize the issuance of all general obligation bonds issued by the State.

Q5: Who administers the GO bonds?

A5: The State Department of Budget and Finance, pursuant to chapter 39, *Hawaii Revised Statutes*, administers the GO bonds issued by the State.

Q6: Is there a limit to how much GO bonds the State can issue?

A6: Yes. The Hawaii Constitution provides a limit--known as the "debt limit"--on the total amount of indebtedness (*i.e.*, payments of principal and interest) that may be incurred each fiscal year. The state debt limit for a given fiscal year is equal to 18.5% of the State's average general fund revenues for the three preceding fiscal years.

In other words, the total amount of principal and interest payable on these bonds in any given year cannot exceed 18.5% of the State's average of the general fund revenues in the three years preceding the issuance of the bonds. The maximum the State can borrow is tied to the amount of general fund revenues the State collects. If the State's general fund revenues increase, then the debt limit will also increase; if the general fund revenues decrease, then the debt limit will also decrease.

Q7: Can the State exceed its debt limit?

A7: Yes. The State may exceed its debt limit if an emergency condition is declared to exist by the Governor and concurred to by a two-thirds vote of the members to which each house of the Legislature is entitled.

Q8: Can the counties issue GO bonds?

A8: Yes. The counties are authorized to issue GO bonds pursuant to chapter 47, *Hawaii Revised Statutes.* The full faith and credit of the issuing county backs a county-issued GO bond.

Q9: Do the counties also have a debt limit?

A9: Yes. The funded debt of a county cannot exceed 15% of the total of the assessed values for tax rate purposes of real property in the county. In other words, the maximum the county can borrow is tied to the assessed values of real property in that county.