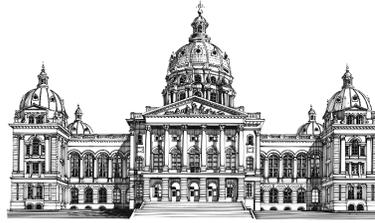


Iowa Legislative Fiscal Bureau



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TRANS Note Issuance

ISSUE

Update on the Tax and Revenue Anticipation Note (TRANS) issuance.

AFFECTED AGENCIES

Office of the Treasurer of State

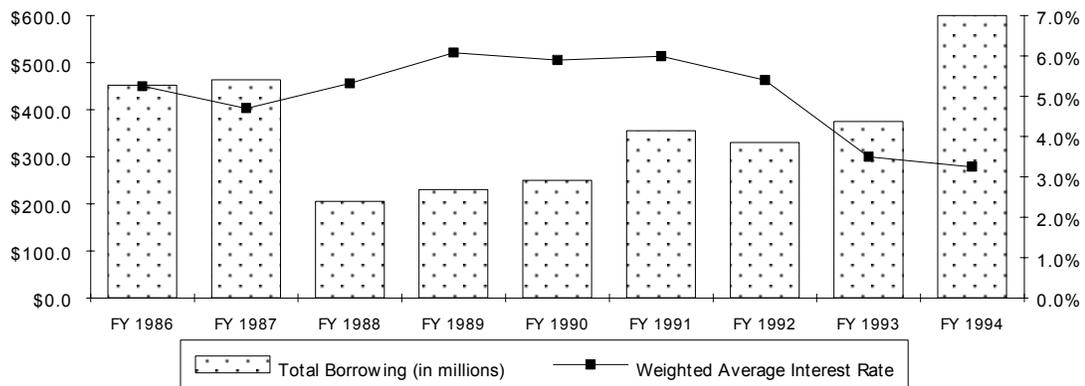
CODE AUTHORITY

Chapter 12.26, Code of Iowa

BACKGROUND

TRANS issuances are a form of State borrowing used to smooth cash flow shortfalls which arise when disbursement needs do not match the timing of revenue inflows. Iowa first began issuing TRANS notes in FY 1986. Table A shows the amount of borrowings by year and the average interest rate the State incurred on those borrowings.

Table A
Total Borrowing and Weighted Average Coupon Interest Rate - FY 1986 to FY 1994

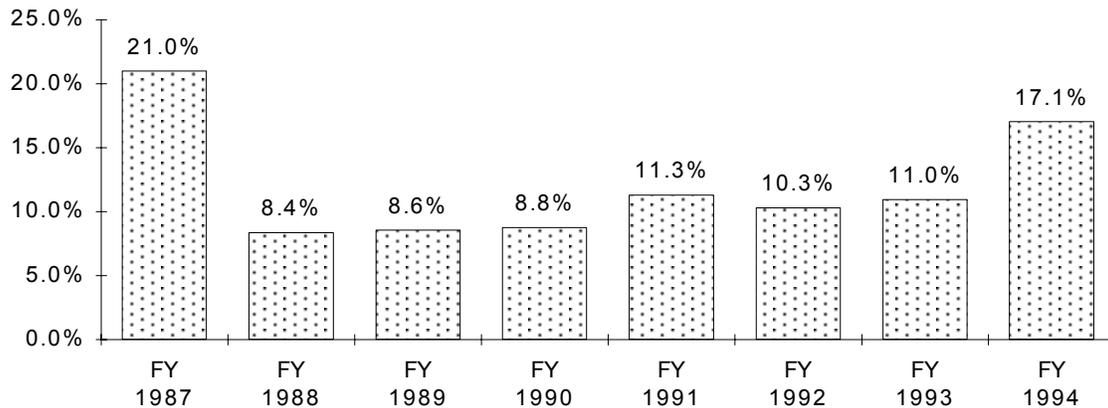


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Table B shows the total TRANS borrowings as a percent of the General Fund budget.

Table B
Total TRANS Borrowing as a Percent of General Fund Budget



CURRENT SITUATION

The rules for TRANS note borrowing have changed. Under the old rules, the State had to spend 90.0% of the borrowing within 6 months following issuance. For the FY 1994 issuance, the U.S. Treasury Department ruled the State can fund a working capital reserve no larger than 10.0% of previous operating expenditures plus the amount of cash flow deficit. In Iowa's case, the working capital reserve is equal to approximately \$460 million (10.0% times the \$4.6 billion operating expenditures for FY 1993) plus \$160 million of cash flow deficit. The decision was made by the Office of the Treasurer to only borrow \$600 million instead of the approximately \$620 million that could have been borrowed.

Because the State has borrowed more than forecasted to be needed to finance the operations of government, the opportunity for arbitrage profits exists. Arbitrage occurs when something is purchased and sold at the same moment, locking in a profit. In this case, the excess funds (approximately \$440 million) have an interest rate of 3.25%, and the State is able to invest those funds at a rate greater than 3.25%. The projected worst case scenario is that the State breaks even on the TRANS issue, net of letter of credit costs (\$2.3 million) and interest costs. In the best case scenario, the State would make a profit in the range of \$4.0 to \$5.0 million. Because the funds are invested in the short term, it is impossible to know exactly what the arbitrage profits will be until later in the fiscal year. Any arbitrage profits will be deposited in the General Fund.

The last time the State was allowed to issue TRANS notes in excess of projected need was in 1986 (for FY 1987). During that time, the State issued \$463.0 million which was 21.0% of the total General Fund budget. This compares to 17.1% of the total General Fund budget for the FY 1994 issue.

The rules implemented to allow the FY 1994 TRANS note borrowing have been changed. For FY 1995, the State will be able to borrow funds for cash flow deficit but will not be able to borrow funds for the working capital reserve. The State does have the option of excluding any working capital amounts (e.g., the Cash Reserve Fund) which they currently have from the calculation. This allows more to be borrowed than if the working capital amounts were included.

There are situations where it may be of benefit to the State to use existing working capital to finance current operations rather than borrowing via a TRANS issue. When the interest rate on borrowed funds is greater than the interest rate earned on Cash Reserve type funds, using existing funds and paying them back at the end of the year would reduce costs compared to borrowing from outside sources.

ALTERNATIVES

Due to the rule changes for TRANS note issuance, the opportunity for arbitrage will not exist to the extent currently available during FY 1995. However, because TRANS note borrowing rules are set administratively by the U.S. Treasury Department, opportunities may arise in the future for borrowing in excess of need.

BUDGET IMPACT

The borrowing is expected to have a positive impact of approximately \$2.0 million (net of costs). This amount may change depending on the interest rate which the State receives during the fiscal year and the amount of funds available to invest.

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