REPRINT

The 1990-91 Budget:
Perspectives and Issues

State Infrastructure

LAO

Elizabeth G. Hill
Legislative Analyst

State Infrastructure

How Should the Legislature Address the State's Growing Capital Facility Needs?

Summary

The state is faced with a large and growing need to revitalize and expand its infrastructure. Although the state does not have a comprehensive plan to identify its specific capital outlay requirements and the associated costs, it is clear that the state's infrastructure needs are in the tens of billions of dollars. To better identify these requirements, establish priorities and develop an appropriate financing plan for this infrastructure, the state needs a comprehensive multi-year capital outlay plan. Until such a plan is available, however, we suggest the Legislature establish criteria to assess specific capital outlay proposals. We also believe the Legislature should establish standards for maintenance of state facilities and set as a high priority goal the elimination of deferred maintenance.

Based on the large volume of infrastructure needs and the state's current budgetary situation, we conclude that the state will have to continue to rely heavily on bonds to finance infrastructure revitalization and expansion. We believe that when borrowing money through the use of bonds, the state should rely as much as possible on general obligation bonds, rather than lease-revenue bonds, in order to minimize General Fund costs.

As California enters the last decade of this century, it will be faced with great demands to revitalize existing infrastructure and develop new infrastructure to meet the dynamic changes occurring in the state. During the past several years the condition of the state's infrastructure has deteriorated and, except in the area of prisons and to some extent education, very little has been done to increase its capabilities. This situation must be turned around if the state's infrastructure is to accommodate future needs. Failure in this effort could have a significant impact on the social and economic future of the State of California.

In this analysis, we examine some of the major infrastructure related problems facing the Legislature: (1) identifying the state's infrastructure needs (2) setting priorities to meet these needs and (3) establishing a financing plan to carry out the Legislature's priorities.

WHAT ARE THE STATE'S INFRASTRUCTURE NEEDS?

Estimates of Statewide Needs

Available information indicates that the overall magnitude of the demand for improving and expanding the state's infrastructure is large. For example, in 1984 the Governor's Infrastructure Review Task Force reported that over the ensuing 10-year period approximately $29 billion would be needed for deferred maintenance and $49 billion for new infrastructure. For the most part, state expenditures over the intervening six years, with few exceptions (most notably prisons and education), have reflected a status quo effort and have done little to address the needs identified in the Task Force report.

Another indication of the current magnitude of infrastructure needs can be seen from Figure 1, which shows that $18.9 billion will be needed for state and K-12 projects over the next five years. (This amount should be used cautiously because it does not reflect all potential needs due to the incompleteness of the state's planning process, and the plans also may include proposals that do not merit funding.) Moreover, the October 1989 Loma Prieta earthquake heightened the awareness of the need to make the state's infrastructure less hazardous during an earthquake. The state's current plans do not systematically address this issue. Nevertheless, it is clear that the state's infrastructure needs are easily in the tens of billions of dollars.

Figure 1

Projected Capital Needs for the State and K-12 1990-91 through 1994-95

(in millions)

	Five-Year Total
Legislative/Judicial/Executive	$60
State/Consumer Affairs	650
Business/Transportation/Housing	4,990
Resources	470
Health/Welfare	160
Youth/Adult Corrections	3,970
Education	8,560
General Government	30
TOTAL	$18,890

Source: LAO estimates, based on information from departments.

Needs in Specific Program Areas

To illustrate the infrastructure needs of particular programs, we briefly review specific capital outlay requirements in five areas.

Transportation. The 1988 State Transportation Improvement Program (STIP)--the state's current five-year program for all state and federally funded transportation improvement projects--includes about $4.8 billion in highway capital outlay projects scheduled for construction through 1992-93. Resources available through 1992-93, however, fall about $3.7 billion short of funding these projects. To fund this STIP shortfall and to meet other transportation needs identified by the governor and the Legislature, the Legislature enacted Ch 105/89 (SB 300, Kopp), Ch 106/89 (AB 471, Katz) and Ch 108/89 (AB 973, Costa) to provide about $18.5 billion over 10 years (1990-91 through 1999-2000) for transportation purposes through increases in gas taxes, truck weight fees, and issuance of bonds. These additional funds, however, will only be available if voters approve SCA 1 at the June 1990 election. (For a more detailed discussion of these transportation acts, please see the *Analysis of the 1990-91 Budget Bill,* page 263).

Under current law, transportation capital outlay projects are not individually funded through the Budget Bill. Instead, current law requires the California Transportation Commission (CTC) to program projects for funding based on statutory priorities and commission-established guidelines. The commission is also responsible for allocating funds appropriated by the Legislature among projects in this program.

Postsecondary Education. Enrollment in the state's three segments of postsecondary education is expected to grow by between 30 percent and 50 percent over the period 1990 to 2005. Estimates by postsecondary education indicate that $3.6 billion will be required for capital outlay-related expenditures over the next five years. Moreover, several billion dollars more will be needed in subsequent years if the state is to accommodate the enrollments anticipated in 2005.

In addition to the needs generated by enrollment growth, there will be an ongoing need to alter existing facilities to meet changes in academic programs. It will also be necessary to provide sufficient funding to assure that existing and new facilities will be properly maintained and that eventually deferred maintenance will be eliminated. The deferred maintenance problems at UC and CSU, for example, represent multi-million dollar costs. In February 1989, UC estimated $176 million in deferred maintenance and CSU expects a $35 million backlog by July

1990. When this analysis was prepared, the Legislature was considering SB 147 (Hart), which would authorize (as amended January 18, 1990) a $900 million general obligation bond issue to be submitted to the voters at the June 1990 primary election. (Please see the following piece, "Accommodating Growth in Postsecondary Education," for a detailed review of each segment's proposal for campus expansions.)

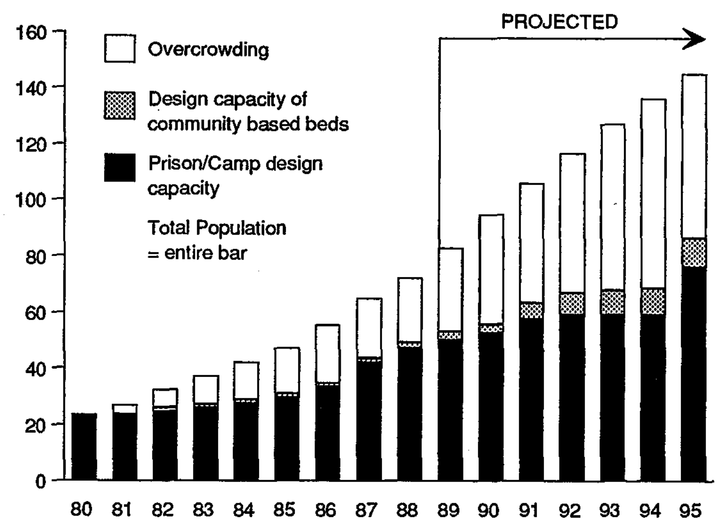
Prisons. In 1980 the inmate population in California's prisons was about 23,500. According to Department of Corrections' projections, that population will be nearly 145,000 by 1995. Thus, in this 15-year period the population in state prisons will have increased *sixfold*. A comparison of this population increase to the physical facilities to accommodate the inmate population is provided in Figure 2.

Since 1980, the Legislature has approved the construction of 41,700 prison beds costing about $3 billion. Even after completion of this massive expansion and assuming the department's overcrowding policy (130 percent of design capacity), the prison system will be 43,900 beds *short* of the expected June 1995 inmate population. To fill this gap, the department estimates that an

Figure 2

State Prison Population and Capacity[a]

1980 through 1995 (inmates in thousands)



[a] Data as of June 30 for each year. Population is based on CDC's fall 1989 projections. Projected design capacity is based on CDC's five-year facilities master plan.

expenditure of about $4 billion will be required over the next five years. Currently, the Legislature is considering SB 842 (Presley), which would place a $900 million general obligation bond issue on the June 1990 ballot.

State Office Buildings. In 1977, the Legislature adopted a Capital Area Plan to coordinate the development and use of state facilities in metropolitan Sacramento. An important element of this plan was the goal to accommodate 90 percent of state office space in *state-owned* buildings by 1987. In 1977, state-owned space represented 64 percent of state office space in Sacramento. Contrary to the stated goal, the proportion of state-owned space fell to 52 percent in 1989. In fact, between 1977 and 1989 total leased space more than doubled and annual leasing costs increased more than sixfold--from $10.1 million to $65.5 million. Meeting the plan's goal for state-owned office space by 1998 would require financing construction of about 3.3 million net square feet, at an estimated cost of around $580 million.

Increase Safety of State Buildings During Earthquakes. A 1981 report from the Seismic Safety Commission identifies 1,350 state-owned buildings in priority sequence (based on life safety considerations) for improving seismic resistance. As mentioned above, however, there is no systematic plan to address this issue. Moreover, the statewide cost to make the necessary improvements is unknown. At the time this analysis was written, the Legislature was considering SB 1250 (Torres), a $250 million general obligation bond proposal to finance the cost of improving seismic resistance of state and local buildings.

WHICH INFRASTRUCTURE NEEDS SHOULD THE LEGISLATURE FUND?

Pending development of a comprehensive multi-year capital outlay plan, the Legislature should establish criteria to assess various proposals according to the Legislature's priorities.

The state's current process for identifying, ranking and financing its capital outlay needs is fragmented. The Legislature receives a series of independent five-year plans in most program areas, but there is no centralized compilation nor ranking of projects across programs to provide a statewide perspective. As a result, there is no easy way to identify the relative priority of those individual projects included in the Budget Bill or the financing required to address overall state needs.

In recognition of this problem, the Legislature enacted SB 2214 (Campbell) in 1988. This bill required the Department of Finance to provide a comprehensive multi-year capital outlay plan for determining needs and setting priorities. The Governor, however, vetoed the measure. Currently, the Legislature is considering an identical measure (SB 348, Alquist). In addition, the State Treasurer recently announced his support for this concept and indicated that legislation would be introduced on his behalf. We believe that adoption of such a plan is an essential element of the state's infrastructure efforts.

In the meantime, however, the Legislature is faced with the difficult task of determining which infrastructure needs to fund in the short term. For the most part, each program area has identified infrastructure projects which merit consideration for funding. Unfortunately, faced with the magnitude of need identified above, it simply is not possible to finance it all at the same time. Thus, the Legislature must rank these competing projects in terms of importance and urgency and then establish a schedule for when and how much funding should be made available. One way of selecting projects that meet the Legislature's priorities would be to establish criteria to apply in individual cases. To aid the Legislature in this effort, we suggest consideration of the following five criteria:

- ***State's Liability.*** Does the proposal correct life threatening security (such as in 24-hour institutions)/code deficiencies or meet contractual obligations?
- ***Urgency of the Service Need.*** Does the project address an existing deficiency or shortcoming (such as severe overcrowding) as opposed to enhancing a service level?
- ***Alternative Approaches.*** Are there less capital-intensive ways to meet the program objective? For instance, can a project be avoided through more intensive or efficient use of existing space?
- ***Alternative Sources.*** Is it appropriate for the *state* to develop this project? In some cases, proposals could be developed using nonstate sources.
- ***Cost Efficiency.*** Will the proposal reduce state costs (through measures such as reducing office building lease costs)?

TAKING CARE OF THE STATE'S INFRASTRUCTURE

We recommend that the Legislature establish a maintenance standard for state facilities and set as a high priority goal the elimination of deferred maintenance.

In addition to financing the revitalization and expansion of the state's infrastructure, the state is also faced with the task of extending the useful life of its infrastructure through proper maintenance programs. Because of the aging of existing facilities and the construction of new infrastructure, there will be an increasing demand on the state's resources to maintain the systems in efficient and economic operating condition. To assure that this happens, the state must place a high priority on maintenance.

The Governor's Infrastructure Review Task Force reported in 1984 that during the next decade approximately $29 billion would be needed for deferred maintenance. The task force recommended that deferred maintenance be designated as the state's highest funding priority. During the intervening years the deferred maintenance problem has not lessened and has probably gotten worse. The difficulty in identifying the extent of the problem is that funding for maintenance efforts are generally lumped together in the budget with other support costs under a single line item "facility operations." This also makes it quite easy to use these funds for purposes other than the specified maintenance. In contrast, state office buildings under the Department of General Services are maintained from a dedicated source (the Building Rental Account) that receives revenues from rent charged to those departments occupying the building. In general, these office buildings are well maintained and there is no deferred maintenance.

The consequence of not fully funding regular maintenance is the steady erosion of the state's capital assets. In the near term, this erosion is less evident. Within a short period of time, however, these assets either require higher-than-necessary costs to be operated and properly maintained, or they must be replaced at a high cost before the end of their normal useful life.

To begin addressing this issue, we believe the Legislature should establish standards for maintenance of state facilities and set as a high priority goal elimination of deferred maintenance. There are several steps the Legislature could take to begin moving the state in this direction. For example, the Legislature could require departments that have a large capital outlay budget to:

- Establish a preventive maintenance program;
- Identify specific elements of infrastructure (maintenance, deferred maintenance, special repair, etc.) by line item in the budget (the Legislature could also add budget language restricting the transfer of these funds for other purposes); and
- Provide a post audit report identifying how the appropriated funds were used and how the deferred maintenance backlog is being reduced.

HOW CAN THE STATE FINANCE ITS INFRASTRUCTURE NEEDS?

As discussed in our Policy Brief *Bonds and the 1990 Ballots* issued in January 1990, there are three basic ways that the state can finance infrastructure projects. The state can:

- Pay "up front" through direct appropriations of state revenues;
- Rent, lease or lease-purchase from private parties through annual rental payments; and/or
- Borrow money by issuing bonds that are repaid with interest.

The state uses each of these financing methods in its capital program but relies most heavily on bonds. Financing a project using bonds is about 25 percent more costly than through direct appropriation (after adjusting for the effects of inflation). Nevertheless, given the large volume of infrastructure needs and the state's current tight budgetary situation, there simply is not enough money available to rely primarily on direct appropriations. As a result, we believe the state will have to continue to rely to a great extent on bonds, if these needs are to be met.

The state has generally relied on two types of bonds:

General Obligation Bonds. The use of general obligation bonds is dependent on approval of each bond proposal by a vote of the people. These bonds are backed by the state, meaning that the state is obligated to pay the principal and interest costs on these bonds. Typically, General Fund revenues are used to pay these debt costs. Currently, the main benefits of using this method of borrowing money is that the interest costs are lower than other methods and debt service payments are exempt from the state's appropriation limit.

Lease-Revenue Bonds. Recently, the state has placed an increasing emphasis on using lease-revenue bonds, particularly in the areas of prisons and postsecondary education. Authorization to issue these bonds is *not* dependent on voter approval and the debt is *not* backed by the "full faith and credit of the state." Nevertheless, the lease payments on these bonds (paid from the General Fund) must be included in any calculation of the state's General Fund debt-service.

An advantage of this method of borrowing is that the state does not have to wait until a general election and therefore can respond more quickly to certain infrastructure needs. The disadvantages are: interest rates are higher than general obligation bonds (by up to 0.5 percent), there are certain other costs that are incurred (such as insurance), and the debt service payments are subject to the state's appropriation limit. (However, under the provisions of SCA 1--on the June 1990 ballot--it appears that the Legislature could exempt these payments from the appropriations limit.)

Given the fiscal advantages of general obligation bonds over lease-revenue bonds, we recommend that the Legislature rely to the maximum extent possible on the former when addressing its infrastructure financing needs. A comprehensive capital outlay plan would help the Legislature achieve this end through improved planning and scheduling of necessary general obligation bond measures for future ballots.

It is, of course, important that the state not indiscriminately issue bonds, thereby incurring excessive indebtedness. However, as our Policy Brief noted, California has a debt burden that is relatively low, enjoys high credit ratings, and can issue more bonds without being financially imprudent.

CONCLUSION

The state must improve and expand its infrastructure to eliminate deficiencies and to accommodate future demographic and economic growth. Based on recent reports and information from various state departments, it is clear that the state's infrastructure needs over the next 15 years are easily in the tens of billions of dollars. In view of the magnitude of these costs, the state must be able to identify specific needs, set priorities and establish a financing plan to carry out the necessary expansion and improvements.

In order to accomplish this effectively, the state needs a comprehensive multi-year capital outlay plan. Until such a plan is available, however, the Legislature is faced with determining which infrastructure needs to fund in the short term. To do this, we suggest that the Legislature establish specific criteria against which various proposals can be assessed. Furthermore, to properly maintain the state's infrastructure, the state needs to place a high priority on maintenance and the elimination of deferred maintenance. Finally, to undertake the necessary revitalization and expansion of its infrastructure, the state will have to rely heavily on borrowing money through the issuance of bonds. In such cases, we believe that the Legislature should rely to the maximum extent possible on general obligation bonds rather than lease-revenue bonds.

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