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The 1991-92 Budget:
Perspectives and Issues

Uses of State Bond Proceeds

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Uses of State Bond Proceeds

How Can the Legislature Ensure That Proposed Uses of Bond Proceeds Are Consistent With Its Objectives?

Summary

The state is faced with a large and growing need to revitalize and expand its infrastructure. As discussed in the preceding analysis, doing this requires that it rely on bonds as a financing source. As the state continues to increase its use of bonds for capital projects, it becomes ever more important that the bond funds be used in ways that maximize their effectiveness in achieving the state's capital outlay goals. Changes to the state's capital outlay planning process, as we also discuss in the preceding analysis, will improve effectiveness by helping the Legislature to identify its highest priorities for funding. Another means of improving effectiveness is to ensure that specific expenditures of state bond funds for such items as support costs are consistent with the Legislature's overall objectives for the use of bond funds.

Our review indicates that there has been a definite broadening in recent years as to the purposes for which bond proceeds are being used. Although some of these expanded uses of bond proceeds are appropriate, others appear to be inappropriate. There also are other current and potential uses of bond proceeds for nontraditional purposes that may be "eligible" for bond funding from an accounting perspective, but raise fiscal policy questions that should be reviewed by the Legislature. We also believe that the Legislature and the administration need to exercise greater oversight over the use of bond fund proceeds in the future, in order to ensure that the uses of bond funds represent good fiscal policy and are consistent with the provisions of the bond acts.

The Legislature can best address these concerns through the adoption of legislation identifying its specific preferences for the use of bond funds and requiring the provision of better information as to the actual and planned expenditure of bond fund proceeds.

The state's large and growing infrastructure needs will require the expenditure of large sums of money if they are to be successfully addressed. The state's current budgetary situation effectively precludes the use of current revenues to meet any more than a small fraction of these needs, so that the passage of additional bond issues will be required. Bond issues will allow the costs of these needed capital outlay projects to be spread over time, thereby making them more affordable from a budgetary perspective. However, the debt service on these bond issues still represents a sizeable cost to the state, and, as the November 1990 election shows, new bond issues should not be considered an unlimited resource. Thus, it is important that the Legislature attempt to maximize the effectiveness of its available bond resources so that these bond issues deliver as much new infrastructure as possible. It also is important that the state incur the added interest costs of using bonds only for those purposes for which these extra costs can be justified.

In this analysis, we examine four important trends we have identified in the use of state bond funds over the last 10 years. In each case, we provide specific examples from various program areas to illustrate the nature of these trends. In the second section, we provide a discussion of the major issues that the Legislature should consider when deciding whether to approve the appropriation of bond fund monies for various purposes, especially those purposes which are distinguishable from the actual acquisition of capital assets. The third section discusses the need for greater oversight of the actual expenditures made from bond funds.

TRENDS IN THE USE OF BOND FUNDS

The four trends we have identified relating to the use of bond fund proceeds include their use for: bond program administration, a variety of departmental support purposes not involving construction, interest expenses on interim financing, and statewide bond overhead costs incurred by the Treasurer and Controller.

Bond Fund Expenditures for Bond Program Administration

One trend in the state's use of bond funds over the last 10 years has been an increased expenditure of bond funds to support the direct administrative costs of certain bond programs—that is, to pay for the department's costs for managing the program being funded by bond proceeds. The increased usage of bond funds for this purpose appears to have stemmed directly from the increased approval of bond programs requiring departmental administration, rather than any fundamental change in policy.

Bond proceeds have traditionally been used by the Office of Local Assistance (OLA) in the Department of General Services for the administrative costs of the State School Building Aid Program. In 1982, the office also began to administer the State School Building Lease-Purchase Program. In both cases, the OLA received its operating funds from the proceeds of general obligation bonds approved by the voters for school facilities construction. The OLA uses the bond funds to support staff who review and evaluate school district applications for bond funding and who administer the release and distribution of funds to school districts.

The use of bond monies for bond program administration also shows up in other departments after the early 1980s. For example, in 1984-85, the Board of Corrections began to use bond fund monies for bond program administrative expenses, spending a total of $575,000 in that year. For 1990-91, the board expects to spend a total of $2.2 million from bond funds to pay for bond program administrative costs. This includes salaries and related operating expenses of staff who (1) review plans and award grants of bond funds for construction and remodeling of county jail facilities and (2) inspect these facilities once constructed.

Similarly, Proposition 70 specifically allocates $1.6 million to the Wildlife Conservation Board and allows the Department of Parks and Recreation to spend up to $7.4 million for program administration. These monies are primarily used to pay departmental staff to perform general administrative tasks related to the bond program, including planning and development studies, and for grant administration. Some of the bond funds also are used to pay the State Lands Commission for property title searches and ownership verification activities required by Proposition 70. Finally, in the housing area, the Department of Housing and Community Development will have spent a total of almost $13 million by the end of 1991-92 on staff and related expenses to establish and manage a new housing loan program to be funded from bond proceeds.

Bond Fund Expenditures for Departmental Support Purposes Not Involving Construction

Through the early 1980s, the use of bond fund monies for departmental support purposes was largely limited to activities associated with the actual construction of new facilities. These project-specific support costs include financing for departmental planning and construction activities, and for performance of contract administration and construction management. There were certain exceptions to this general policy, however. For example, the State Water Resources Control Board (SWRCB) has traditionally had specific authorization to use bond funds to pay for a wide variety of support costs, including planning, studies, monitoring, and technical assistance, even in cases where the program support activities are not directly related to a specific project.

Beginning in 1985-86, the general policy described above was expanded to encompass a wider range of expenses related to capital outlay projects, but not involving the actual construction of new facilities. For example, in 1985-86 the Department of Corrections expanded its use of bond funds to include special *repair* programs in *existing* prisons, and legal defense for the department against claims arising from the construction program. In 1987-88, the department began to use prison bond funds for *maintenance* projects associated with *existing* facilities.

The *1990-91 Governor's Budget* proposed to further expand the use of bond fund monies by using them to pay for the *start-up operating costs* of the state's four newest prisons. These proposed expenditures totaled $26.4 million in 1990-91, and reflected costs for such items as inmate laundry, electricity, and staff relocation. The budget also proposed to expand the California Youth Authority's (CYA) use of bond fund monies for program support by allocating a total of $1.2 million from the 1990 Prison Construction Bond Fund (approved on the June 1990 ballot) for start-up costs related to the CYA's newest facility. These start-up costs included expenditures for ward education, recreation, and clothing, housekeeping, and maintenance of structures, grounds, and equipment. The Legislature rejected these proposals, however, choosing to fund these costs instead from direct General Fund appropriations.

The *1991-92 Governor's Budget* generally does not propose to expand the types of purposes for which state bond funds are expended, but does propose that past practices in this area be continued and, in one case, expanded. In the proposed budget for the Department of Corrections, for example, the administration is seeking authority to increase its expenditure of existing bond funds to pay for planning activities associated with proposed new prisons—prisons for which the department has no construction funding at this time. These prisons had been intended to be funded from a bond measure on the November 1990 ballot that was rejected by the voters.

The expansion in the types of expenditures made from bond funds can also be seen in some of the bond programs that have been established by initiatives in recent years. For example, Proposition 70 (the 1988 parks bond) specifically allocates $11 million to the Department of Fish and Game (DFG) for capital purposes other than the traditional "bricks and mortar" type capital facilities. These costs include restoration and enhancement of salmon streams ($10 million) and purchase of marine patrol boats ($1 million). In addition, Proposition 70 allows the DFG to spend $6 million on activities related to wild trout habitat, including program support activities if the department chooses.

Bond Fund Expenditures for Interest on Interim Financing Loans

A third trend we have identified is the state's use of bond fund monies to pay interest charges on interim loans provided to the bond programs. In 1987 the state passed Ch 6/87 (AB 55, Roos), which allows bond fund programs to begin operation before the bonds are actually sold by borrowing money from the state's Pooled Money Investment Account (PMIA). Prior to 1987, the state sold bonds once they were authorized, even if particular projects were not ready to begin construction. The state invested the idle bond proceeds until the funds were needed for project construction. In 1986, however, the federal government passed strict new laws governing the use of tax-exempt bonds. These laws effectively precluded the state from continuing this practice, and the state enacted Chapter 6 to bring state practices into compliance with the new regulations. Under Chapter 6, the state has delayed the sale of bonds until after most of a project's expenditures (funded initially from a PMIA loan) are incurred. As project expenditures are completed, bonds are sold to repay the loans from the PMIA, and thereby refinance the project.

Chapter 6 provided that the interest on these loans would be paid directly from the state's General Fund. In 1988, however, Ch 984/88 (SB 2172, Campbell) revised the law to require that the interest on PMIA loans be paid from the *bond proceeds* (with certain exceptions), instead of the General Fund. This change was made to free up General Fund revenues in the *short term* for other state programs, although it resulted in higher costs to the state in the *long term,* because of the interest charges required to be paid by the General Fund on the outstanding long-term debt.

The total amount of interest on PMIA loans to be paid from bond funds is estimated to be approximately $55 million in 1990-91 and $26 million in 1991-92. These figures are significantly lower than previous estimates, which ranged up to $100 million annually, because of recent changes in federal tax law. These changes allow the state a longer period of time over which the proceeds of a bond sale may be spent without resulting in a penalty, and will in most cases eliminate the need to rely on interim financing in the future. As a result, in 1990 the State Treasurer's Office began to plan for the accelerated sale of bond issues and a corresponding reduction in the use of interim financing loans. Further, in January 1991 the Treasurer's Office announced its intention to completely phase out the interim financing program.

Bond Fund Expenditures for Statewide Bond Overhead Costs

The final trend is the state's increasing reliance on bond fund monies to cover the statewide overhead costs incurred by the Treasurer and the Controller for managing bond issues. For example, in 1987-88 the administration required these offices to begin charging various bond funds to recover a portion of their costs for management of the state's bond issues. According to the Treasurer's Office, the expenses covered by this new policy arise from the following kinds of activities:

- Administering loans from the PMIA for the purpose of carrying out a program or project that is to be financed by eventually issuing bonds.
- Assuring bond program compliance with federal laws and regulations.
- Providing services related to arbitrage tracking and special financial arrangements for bond sale proceeds.
- Other general administrative costs in the Treasurer's executive office that are related to management of the state's bond issues.

The amount of bond funds expended to reimburse the Treasurer and Controller for the overhead activities described above totaled $747,000 in 1988-89, $2.2 million in 1989-90, $3 million in 1990-91, and is projected to total $3.5 million for 1991-92. In the context of the Treasurer's total costs related to bond fund programs (approximately $6 million in 1990-91), these reimbursements represent a significant portion (50 percent) of the funding for statewide bond-related overhead. Based on our discussions with the Treasurer's Office, it appears that the administration's policy since 1988 has been to fund all new or increased costs related to the management of bond issues from bond funds, while maintaining General Fund support for the remainder of the state's costs in this area.

POLICY ISSUES RAISED BY STATE BOND FUND EXPENDITURE PRACTICES

Over the last 10 years, the state has both increased its overall use of bond funds and, as described above, expanded the type of expenditures made from bond fund monies. These changes are responsible for the large increase in bond fund expenditures characterized as "state operations" over the last 10 years. These types of expenditures have grown from only $8 million in 1980-81 to an estimated $136 million in 1990-91. As noted earlier, some of this increase reflects the state's overall increase in the use of bond funds for capital projects generally. Some of the increase, however, also reflects changes in state policy regarding the kinds of support, administrative, and overhead costs the state chooses to pay from bond funds.

The trends in bond fund usage we have described above lead us to the conclusion that the Legislature should establish a comprehensive policy to guide decision-makers in allocating the proceeds of bond issues. Such a policy would help ensure the allocation of bond funds in a manner which is consistent with the objectives of the bond acts as well as the Legislature's preferences for the use of these funds.

What Principles Should Guide the Legislature?

In developing a policy to guide the allocation of bond fund monies, the Legislature needs to consider the following three basic issues.

- Are particular uses of bond funds consistent with the provisions of the bond acts approved by the voters?
- Can particular uses of bond funds be considered to be directly related to the acquisition of the capital asset for which the bond issue was approved?
- What are the Legislature's preferences for limiting the extent to which bond funds may be used?

As these issues indicate, there are essentially three steps to the development of an allocation policy for bond proceeds. The first step is to determine whether or not a particular use of bond funds should be *precluded* from further consideration because it is not consistent with the provisions of the bond act. The second step is to determine whether a particular use should be *eligible* for further funding consideration because it either (1) involves construction or (2) otherwise is related to the acquisition of capital assets. The final step is for the Legislature to determine which of the eligible uses *should* actually be funded from bond proceeds, given its fiscal and other policy preferences. The remainder of this section discusses these issues in greater detail.

Consistency With the Bond Acts

The State Constitution (Article XVI, Section 1) restricts the use of bond funds to the specific objects of expenditure that are set out within the individual bond acts. Individual bond acts typically require or allow specific types of expenditures, and any expenditures that fall within these specifications should be considered to be consistent with the bond acts. In some cases, however, the state has made expenditures of bond funds for activities which are not specifically mentioned in the bond acts. In these cases, the administration has contended that the uses of the bond funds are "reasonably subsumed within the activities contemplated by the voters in approving the bond acts," and thus are consistent with the constitutional restrictions. However, two recent Legislative Counsel opinions call this contention into question.

In the first case, as described earlier, in last year's budget the Department of Corrections proposed to pay for a variety of operating costs from the 1990 New Prison Construction Bond Act (approved at the June 1990 election). That act states that "the moneys in the fund shall be used for the acquisition, construction, renovation, remodeling and deferred maintenance of state youth and adult correctional facilities." The act does not specifically authorize the use of funds for the *operation* of correctional facilities, however. According to a 1989 Legislative Counsel opinion, while some moveable equipment may be legitimately purchased with bond funds, consumable materials or supplies (such as expenditures for laundry or electricity costs) do *not* fall into the authorized categories (acquisition, construction, etc.). On the basis of Legislative Counsel's opinion, these types of support costs would be precluded from bond act funding.

In the second case, a similar situation occurs with respect to the use of bond funds to reimburse the Treasurer and Controller for their costs in managing the state's bond programs. The state's General Obligation Bond Law, which is incorporated by reference into the bond acts, provides that the bond proceeds may be used to pay for the direct costs of bond issuance, such as printing of the bonds and the fees for the bond underwriters and legal counsel. From a capital budgeting perspective, these types of costs are allocable to capital projects and on this basis a case could be made to fund them from bonds. However, we have been advised by the Legislative Counsel that the use of bond funds to pay the state's overhead costs related to bond programs violates the provisions of the bond acts and the State Constitution. As a result, this type of administrative expense also would be precluded from bond act funding, at least as far as the costs associated with already enacted bond measures. The Legislature could choose to include specific authorizations for these types of expenses in future bond acts.

Relation to the Acquisition of Capital Assets

The state has in past years issued both general obligation bonds and revenue bonds funded by the General Fund as a means of increasing its ability to acquire long-lived capital assets. If these assets were to be acquired on a pay-as-you-go basis, the state would face a significant problem in raising the large amount of funds required for the needed capital facilities, given the level of demands already placed on the state budget by ongoing programs. By spreading the cost of these facilities over longer periods of time, bond issues allow the state to make currently needed investments in infrastructure, such as schools and prisons. The annual cost of servicing the debt issues is also easier to accommodate within the budget context, and more closely matches the "consumption" or usage of the benefits that these facilities provide.

It is important to recognize, however, that the bonds are merely a financing tool for acquiring long-lived capital assets. As such, their use should be limited to that purpose, and not expanded to pay for activities that provide only short-term benefits, are not project-specific, or are unrelated to the actual acquisition of a capital facility. Limiting the use of bond funds for these types of expenditures not only makes sense in its own right, but also helps to ensure that the available bond monies will be sufficient to achieve the intended purpose of the bond acts. Thus, we would suggest that the Legislature consider, in determining whether a particular type of expenditure is "eligible" for bond financing, whether that expenditure is *necessary* to the *acquisition* of a *specific* capital asset.

Applying the Eligibility Criterion. Applying this criterion requires a certain amount of judgment. This is because not all types of expenditures fall neatly into a category of "appropriate" or "not appropriate" for bond financing, resulting in there being many "grey" areas. Keeping this in mind, the above criterion generally suggests the following regarding whether different types of expenditures should be considered as eligible candidates for being funded through bonds:

- ***Direct capital costs of acquiring facilities.*** The direct "brick and mortar" type costs of acquiring capital facilities clearly *are* consistent with the above criterion.
- ***Acquisition-related departmental support costs.*** As noted earlier, the state has traditionally funded the project-specific departmental support costs associated with acquisition of capital projects from bond funds. Because these costs are necessary to acquire the specific

capital facilities, they also appear to be *consistent* with the eligibility criterion discussed above.

- ***Other types of departmental support costs.*** Other program support costs, including those relating to capital facilities such as operations and standard maintenance costs at existing prison facilities, would *not* be eligible under the above criterion. Although it is true that maintenance activities can help to extend the useful lives of capital facilities, most are an ongoing basic cost associated with the operation of these facilities. As such, they should be financed from current revenues unless they involve substantial capital expenses and extend a facility's useful life significantly beyond what it normally would be.
- ***Bond program administrative costs and interim financing.*** It is our view that these costs *should* be considered eligible for bond financing because they are necessary to acquire the capital projects. For example, the review of plans for county jails helps to ensure that certain standards of quality are achieved for specific jail facilities, so that the facilities provide the long-term benefits contemplated by the voters in approving the bond acts. Likewise, the costs of interim financing are directly related to the construction phase of a capital project, although they may only be needed in limited situations from now on due to the recent federal law changes discussed earlier.
- ***Statewide bond overhead costs.*** Expenses incurred by the Treasurer and Controller for managing bonds that are clearly allocable to specific projects *would* qualify under this criterion. An example is the cost of writing checks to investors to pay interest on or redeem the bonds used to finance a facility. In contrast, an argument can be made that expenses for the ongoing day-to-day responsibilities inherent to these offices—such as for basic staffing, keeping abreast of financial market developments, maintaining contacts with financial market representatives, and preparing required government reports—would *not* be eligible.

Legislative Preferences for Bond Fund Usage

The final step in the development of a bond fund allocation policy is the determination of the Legislature's fiscal and other policy preferences for the use of bond funds. In other words, even if a proposed expenditure meets the first two conditions in that it is consistent with the bond act and related to the acquisition of a capital asset, the Legislature may decide not to use bond funds for other reasons. Some of these reasons may include:

- ***Minimizing long-term General Fund cost impacts.*** By limiting the extent to which bond funds are used to finance *all* eligible costs of a capital project, the Legislature can reduce the cost impact of specific projects on future state budgets. For example, the practice of paying the interest on interim financing loans from bond funds results in higher costs to the state in the long run. This is because the General Fund is responsible for ultimately paying off the bonds and thus ends up paying "interest on interest."
- ***Stretching available bond fund resources.*** A great deal of discussion has occurred concerning the possibility that increased reliance on bond financing will result in the state becoming "over-bonded" at some point in the future. Our analysis suggests that the state presently is in no danger of this occurring. However, if the state were to adopt policies limiting the amount of bond issues submitted to the voters during each election year, this could exacerbate the competition which already exists among potential bond authorizations for placement on the ballot. Under these circumstances, limiting the use of bond funds to those types of expenditures *most directly needed* to acquire capital assets could allow a greater number of projects to be undertaken.

In both of these cases, there is a short-term/long-term tradeoff to be considered. That is, eligible project costs *not* funded by bond proceeds will have to be funded from current revenues, thereby reducing the amount of current revenues available to fund other state programs. On the other hand, by not funding such costs from bond proceeds, the Legislature avoids debt service costs, thereby freeing up *future* General Fund revenues for future state expenditure needs and/or allowing the available bond resources to permit acquisition of a greater number of capital facilities. Thus, while we have no basic disagreement over the need to incur the types of expenditures we have discussed in the first section of this analysis, we believe that the Legislature should consider whether the use of bond funds to pay for them is consistent with its fiscal policy and other objectives.

Given the above, ***we recommend that the Legislature enact legislation to clearly identify the types of expenditures that it does and does not want to pay for with bond proceeds.*** As noted earlier, at a minimum, legislation is needed to authorize or specifically prohibit the charging of statewide bond overhead costs to bond funds, because *the existing practice violates state law and the State Constitution*. In addition, the Legislature should determine whether it wishes to limit the extent to which bond proceeds may be used for departmental support, bond program administration, and interim financing, and specify the criteria upon which these determinations shall be made.

OVERSIGHT OF BOND FUND EXPENDITURES

The state's bond activity has grown and become more complex in recent years. However, there has been no concurrent improvement in the systems necessary for adequately tracking and monitoring bond fund expenditures. The Legislature has access to information about bond fund expenditures, largely through the bond fund condition statements presented annually in the Governor's Budget. Yet, despite the growth and increased complexity of the state's bond activities, the fund condition information that the Legislature currently receives is little different from the information it received 10 years ago.

In this context, the bond fund condition information presented is deficient in two ways. First, the information presented is often misleading, because it does not consistently account for all of the charges against a particular bond fund. For example, the fund condition statements in many cases fail to reflect charges for PMIA loan interest and statewide bond-related overhead expenses. Second, in some cases, the Governor's Budget presents no fund condition information at all. Thus, the Legislature does not now have a complete picture as to the availability of bond funds when it is considering how these funds should be allocated for various projects, and the amount of additional bond funds that should be placed before the voters for their approval.

This lack of information regarding the availability of bond monies can have serious financial consequences. For example, the 1986 Community Parklands Act authorized the sale of $100 million in bonds to fund population-based grants for local parks and recreation projects. The act provided for allocation of the entire $100 million to local agencies (with a provision for the payment of a small amount of departmental administrative costs from the bonds). Pursuant to Chapter 984 (as described above), however, that bond fund must also pay the interest on the interim financing it receives from the PMIA. Since the information as to the amount of interest costs that would eventually have to be paid from the bond proceeds was not made available to it, the Legislature made commitments of the bond funds that exceed the amount of money that will eventually be available. Thus, without an outside source of funds, the department will have to reduce the amounts of individual local assistance grants that already have been awarded and allocated to local agencies in order to pay the PMIA interest costs.

The *1991-92 Governor's Budget* does a better job than previous budgets of accounting for bond fund expenditures. It includes information as to the amount of interim financing charges that will be assessed against most of the affected state bond funds, and, in some cases, has also identified the bond program administrative costs. It still does not, however, identify charges for statewide bond program overhead costs or provide fund condition statements for all state bond funds.

Thus, while the state's bond activity has expanded and grown more complex, the systems needed to track bond fund expenditures have not been adequately improved to meet the increased need for oversight. As the above examples demonstrate, greater legislative and administrative oversight is needed to ensure that the state's bond programs are managed effectively.

Toward this end, ***we recommend the enactment of legislation requiring the inclusion in the Governor's Budget of fund condition statements for all state bond funds, and the inclusion in such statements of all charges that will reduce the amount of such funds available for appropriation by the Legislature.***

CONCLUSION

In conclusion, we recommend that the Legislature consider the issues raised above in making future decisions on what bond fund allocations are desirable and appropriate. Specifically, we recommend that the Legislature enact legislation specifying a policy to guide it in allocating bond funds. This will help to ensure that proposed allocations are consistent with the provisions of the bond acts, that they are necessary for the acquisition of capital assets, and that they are consistent with the Legislature's fiscal policies and other objectives. This legislation also should impose new requirements for the reporting of all bond fund expenditures in the Governor's Budget.

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