An LAO Report

A Primer on State Bonds

Introduction

In 1998, the Legislature will face important decisions regarding bond financing and addressing the state's infrastructure needs. California's economic growth and quality of life are in part dependent on the adequacy of the state's public infrastructure. The Governor has proposed a significant amount of new bond authorizations in several program areas.

In order to assist the Legislature, this report provides answers to questions often asked about bond financing by the state. In addition, we describe the Governor's bond package, its impact on future state budgets, and key factors the Legislature should consider in evaluating any bond proposals.

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January 30, 1998

What Are Bonds Used For?

Bonds are used by the state to finance capital outlay projects and the acquisition of land. Capital outlays include projects to construct or renovate buildings and other infrastructure.

Why Does the State Use Bond Financing?

Bonds allow the state to acquire expensive assets that it could not afford on a "pay-as-you-go" basis. The state borrows money from investors and then repays the borrowed money (principal), plus interest, over a period of years. This is similar to an individual borrowing money from a bank to purchase a home and then repaying the bank over a number of years. Recognizing that the costs of paying off the bonds are shared with future taxpayers, bonds should only be used for long-lived assets, rather than ongoing operating costs.

What Types of Bonds Does the State Issue?

The state issues general obligation (GO) bonds, revenue bonds, and lease-payment (lease-revenue) bonds, which are described below. When people talk about what bonds to place on the ballot, they are usually referring to GO bonds (non-self-liquidating).

Type of Bond	Recent Uses of Bond Proceeds	Voter Approval Needed?	Amount Outstanding[a]
			(In Billions)
State Pays Debt Service			
General obligation (non-self-liquidating)	School and college facilities, seismic retrofit, parks, and water projects.	Yes	$14.9
Lease-payment	Prisons, college facilities, and state office buildings.	No	6.4
State Does Not Pay Debt Service			
General obligation (self-liquidating)	Veterans housing.	Yes	$3.8
Revenue bonds	State Water Project, college dormitories, and nonpublic projects.	No	22.2[b]

[a] As of December 31, 1997 unless otherwise noted.
[b] As of September 30, 1997.

What Bonds Have Recently Been Approved?

The figure below shows the GO bonds approved since 1986 by program area. From 1986 through June 1990, voters approved over 90 percent of all proposed GO bonds, but from November 1990 through 1994, only 30 percent were approved. Voters approved all $6.4 billion in bonds proposed in the 1996 elections.

In addition, since 1986 the Legislature has authorized $6.4 billion in lease-payment bonds for the following purposes: Corrections—$2.6 billion; higher education—$2.4 billion; state offices and laboratories—$2.5 billion.

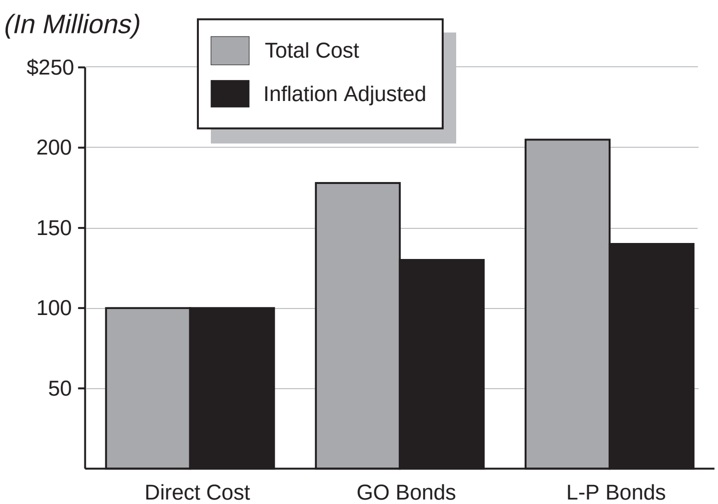
(Bond Amounts in Millions)

BOLD = Passed
NORMAL = Failed

	1986		1988		1990		1992		1993	1994		1996	
Program	**Jun**	**Nov**	**Jun**	**Nov**	**Jun**	**Nov**	**Jun**	**Nov**	**Nov**	**Jun**	**Nov**	**Mar**	**Nov**
K-12 Education		**$800**	**$800**	**$800**	**$800**	**$800**	**$1,900**	**$900**		$1,000		**$2,025**	
Higher Education		**400**		**600**	**450**	450	**900**			900		**975**	
Corrections/Youth Authority		**500**		**817**	**450**	450							
Veterans (self-liquidating)	**$850**		**510**			**400**							**$400**
State/Local Parks, Natural Resources	**100**		**776**			437				2,000			
Water	**150**	**100**		**200**		380							**995**
Housing			**150**	**300**	**150**	315			$185				
Rail Transportation			1,000		**2,990**			1,000			$1,000		
County Corrections	**495**			**500**		225							
Earthquake Relief and Seismic Retrofit					**300**					2,000		**2,000**	
Other				**75**		230							
Total Passed	**$1,595**	**$1,800**	**$2,236**	**$3,292**	**$5,140**	**$1,200**	**$2,800**	**$900**	**—**	**—**	**—**	**$5,000**	**$1,395**
Total Failed	—	—	$1,000	—	—	$2,487	—	$1,000	$185	$5,900	$1,000	—	—

How Much Does a Bond Typically Cost?

The cost of bonds depends on the interest rates at which they are sold and the length of time until they are paid off. The figure below compares the direct cost of a $100 million project financed on a pay-as-you-go basis and with the total principal and interest payments for the same project using GO and lease-payment bonds.



What Is the Difference Between Debt and Debt Service?

The state's *debt* is the amount of money (the outstanding principal) the state still owes bond investors. *Debt service* is the *annual* amount the state pays to the investors (principal *and* interest).

How Much Is the State's Debt Service?

In the current year, the state will pay an estimated $2.3 billion for debt service on GO bonds (non-self-liquidating) and lease-payment bonds that are secured by the state's General Fund. This amount is about 4.4 percent of the state's General Fund revenues—a measure referred to as the state's *debt ratio*.

What Is the State's Current Bond Rating?

The state's current ratings from the credit rating agencies are: Fitch—AA–; Moody's—A1; and Standard and Poor's—A+.

The state last had a "triple A" rating (the highest possible) back in late 1991. During the recession, the state's rating was downgraded several times, reaching a low of A. The state's improved fiscal condition resulted in an upturn in the ratings.

What New Bonds Is the Governor Proposing?

The figure below shows the $13.2 billion in bond authorizations—$11.7 billion in GO bonds and $1.5 billion in lease-payment bonds—that the Governor is proposing. Of this total, about $6 billion would go on the ballot this year (either in June or November), and $6 billion (all for K-12 schools) would go on ballots in subsequent years.

Program	Amount
General Obligation Bonds	*(In Millions)*
K-12 Schools	$8,000
Water	1,300
Higher Education	1,000
Watershed, Wildlife, and Parks Improvement	800
Local Juvenile Facilities	350
Infrastructure Bank	200
Subtotal	($11,650)
Lease-Payment Bonds	
Department of Corrections—New State Prisons	$1,024
Department of Health Services—Richmond Laboratory, Phase II	116
Department of Mental Health—Atascadero State Hospital Addition	33
Department of the Youth Authority—Security Housing Units	33
Office of Emergency Services—Headquarters Facility	26
Other projects (unspecified)	300
Subtotal	($1,532)
Total	**$13,182**

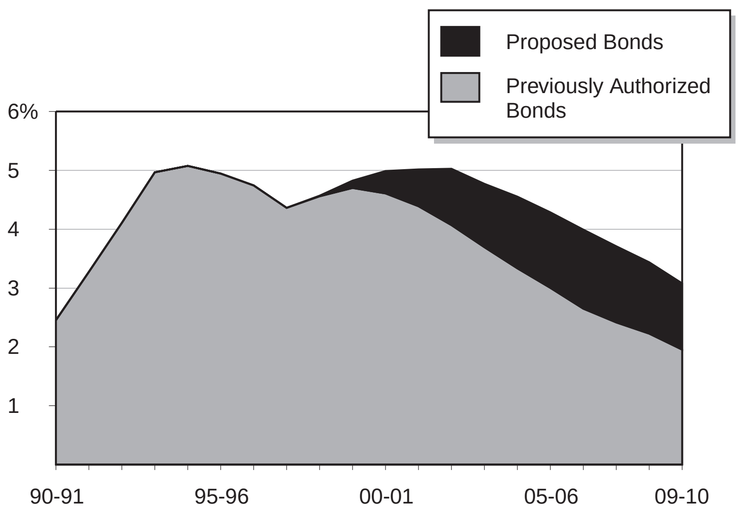
What Factors Should the Legislature Consider in Determining Which Bonds Are Needed in 1998?

The following are some of the key questions the Legislature should ask in considering any bond:

- Is the bond program clearly a state responsibility?
- If the program or facilities to be funded with the bonds are a local responsibility, when and to what extent should the state assist with funding?
- Are the bonds needed this year—in the amount proposed—to finance capital outlay projects that are either (1) ready to proceed or (2) part of a well-defined plan and will be ready to proceed before the next statewide ballot?
- Are there ways to reduce the infrastructure needs of a particular capital outlay program (for example, by making better use of *existing* facilities)?
- Will funding be available to operate and maintain the capital investments?

How Will the Governor's Bond Proposals Affect the State's Debt Ratio?

As shown in the figure, as currently authorized bonds are sold, we estimate that the debt ratio will peak at 4.7 percent in 1999-00 and decline thereafter. With the Governor's proposed bonds, the debt ratio would peak at 5 percent in 2000-01. The actual debt ratio would depend on the timing, volume, and actual interest rates on bond sales, and on actual General Fund revenues.



How Much Annual Debt Service Can the State Afford?

There is no "right" answer to this question. Some argue that the state's debt ratio should not exceed a fixed percentage—say 5 or 6 percent. These are, however, arbitrary amounts which may cause the state to underinvest in high priority projects at critical times. The key consideration is that the state is addressing its highest priority infrastructure needs, in a fiscally prudent manner, consistent with a multiyear capital outlay plan.

Are There Alternatives To Using Bonds?

Yes. The state could, for example, dedicate a larger share of its annual General Fund revenues toward addressing more capital outlay needs on a pay-as-you-go basis. This would provide the state with a stable source of funds to address at least some of its highest priority capital needs each year. In addition, it would save the future General Fund costs of paying interest on the bonds.

Acknowledgments

This report was prepared by Chuck Nicol, under the supervision of Gerald Beavers. The Legislative Analyst's Office (LAO) is a nonpartisan office which provides fiscal and policy information and advice to the Legislature.

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