Policy Brief
periodic analyses of issues before the Legislature

LAO

Bonds and the 1992 Ballots

The Legislature faces critical decisions on the bond package to be placed on the 1992 ballots. In this policy brief, we discuss the many considerations involved in making these decisions in light of the large magnitude of the state's infrastructure needs.

INTRODUCTION

During the upcoming months, the Legislature must decide what general obligation bond measures to place on the June and November 1992 ballots for voter approval. These decisions are important because general obligation bonds are one of the primary ways that the state finances its capital infrastructure needs. How well the state's infrastructure needs are met will greatly influence the state's future competitiveness and economic growth, and Californians' quality of life.

Previously authorized general obligation bonds are insufficient to finance the state's current or future capital infrastructure needs. Without additional general obligation bond authorizations, either fewer infrastructure needs will be addressed or more costly debt financing -- such as lease-payment bonds -- will have to be used.

WHAT ARE THE STATE'S CAPITAL INFRASTRUCTURE NEEDS?

While there are no precise measures of the state's capital outlay requirements, the Legislature has two sources of information regarding the general magnitudes of those needs: the Department of Finance's 10-year capital outlay and infrastructure plan, and the five-year capital outlay plans developed by various state agencies.

The Administration's 10-Year Capital Outlay and Infrastructure Plan

In February 1991, the Department of Finance released its first annual report on the state's 10-year capital outlay and infrastructure needs, pursuant to Ch 1435 (SB 1825, Beverly). As shown in Figure 1, the administration's plan identifies

Figure 1

Department of Finance Projected Capital Outlay Needs 1991-92 through 2000-01

(in billions)

	Ten-Year Total
State Office Buildings	$0.8
Transportation	28.4[a]
Natural Resources and Environmental Quality	5.2
Public Safety	11.4
Education	8.8
Total	**$54.6**

[a] Includes $26.4 billion to be funded from state and federal gasoline tax revenues and state truck weight fees for the Department of Transportation.

Source: Department of Finance, 1991 Capital Outlay and Infrastructure Report.

It seems clear that the state will need to invest tens of billions of dollars in infrastructure over the next decade.

$54.6 billion of state-funded infrastructure needs (at both the state and local levels) over the next 10 years. This total includes $26.4 billion to be financed from special funds and federal funds -- for transportation programs -- and $28 billion to be financed from general obligation bonds.

The administration's plan represents an initial step toward a comprehensive and coordinated state capital outlay planning process. In general, however, the plan does not contain information the Legislature needs in order to assess the condition of the state's infrastructure, set priorities, and determine the amount and purpose of bonds that should be on the June or November 1992 ballots. For instance, the plan does not contain:

- An inventory of capital needs, based on program-by-program assessments.
- A discussion of all areas of infrastructure for which the state has previously provided support. (For example, the plan does not mention such areas as housing, child care facilities, and state health facilities.)
- A proposed schedule for allocating the bonds, by program area, over the 10-year period. (The plan only schedules 1992 bonds for K-12 education and local jails, stating that, after 1992, these programs would be strictly a local responsibility.)

State Agencies' Five-Year Capital Outlay Plans

A project-specific assessment of current state-level infrastructure needs is provided in state agencies' five-year capital outlay plans. According to the plans, as shown in Figure 2, infrastructure needs at the state level, including K-12 education, will amount to about $41.3 billion over the five-year period from 1992-93 through 1996-97. This total includes $12.7 billion for transportation programs (to be funded with federal and state gasoline tax revenues and state truck weight fees) and $28.6 billion in all other needs (typically funded in large part through state general obligation bonds).

Tens of Billions of Dollars Will Be Needed Over the Next Decade

The estimates included in the above plans should be viewed with caution, because the plans are incomplete and also may include proposals that, upon examination, do not merit funding. Nevertheless, recognizing the weaknesses of these plans, we believe they provide a

Figure 2

Projected Capital Outlay Needs For the State and K-12 Education 1992-93 through 1996-97

(in billions)

	Five-Year Total
State/Consumer Services	$0.3
Transportation	15.0[a]
Resources	0.7[b]
Health/Welfare	0.2
Youth/Adult Corrections	4.4
K-12 Education	15.4
Postsecondary Education	5.2
General Government	0.1
Total	**$41.3**

[a] Includes $12.7 billion to be funded from state and federal gasoline tax revenues and state truck weight fees for the Department of Transportation.

[b] Does not include amounts for the Coastal Conservancy, the Santa Monica Mountains Conservancy, the Tahoe Conservancy, or the Wildlife Conservation Board, which do not prepare five-year plans.

Source: Legislative Analyst's estimates, based on information from state departments.

reasonable assessment of the overall magnitude of need in those areas included in the plans. Thus, using these documents as benchmarks, it seems clear that the state will need to invest tens of billions of dollars in infrastructure over the next decade.

HOW ARE THE STATE'S CAPITAL INFRASTRUCTURE NEEDS FINANCED?

There are three basic ways to finance the state's capital infrastructure needs. The state can pay "up front" through direct appropriations, lease or lease-purchase facilities, or issue bonds.

The use of direct appropriations is the least costly method of funding infrastructure needs. Direct appropriations are extensively used in the area of transportation, where gasoline tax revenues and fees support annual spending. In other areas, however, the large amount of funding required -- coupled with the current tight budget situation -- has limited the state's ability to use this financing method. In particular, funding from the Special Account for Capital Outlay (SAFCO) has been reduced considerably in recent years, as less monies have been generated by the state's tidelands and available funds have been redirected for support of ongoing programs.

For the most part, the state has relied on leasing to meet office space needs -- the state leases about two-thirds of its office space. Other than office space, however, reliable leasing markets do not exist to fulfill the state's infrastructure needs. For instance, there is basically no private market for prison facilities or large water facilities.

Given the above limitations, the state relies heavily upon the issuance of bonds to finance these needs. Two types of bonds are extensively used by the state to finance its capital infrastructure needs -- general obligation bonds and lease-payment bonds.

General Obligation Bonds. General obligation bonds require voter approval. The principal and interest (that is, debt service) of the bonds is backed by the full faith and credit of the state's taxing authority. As a result, these bonds carry a lower rate of interest than those that are not fully backed by the state. Payment of debt service comes from the General Fund.

Lease-Payment Bonds. Lease-payment bonds (commonly referred to as lease-revenue bonds or Public Works Board bonds) do not require voter approval. The debt service is paid from the General Fund (usually through annual lease payments made by the state agency using the facility), but is not backed by the full faith and credit of the state. Lease-payment bonds have been rated lower than general obligation bonds and, therefore, require a slightly higher interest rate. As a result of higher rates and insurance requirements, lease-payment bonds cost more than general obligation bonds and, therefore, use up more of the state's debt capacity without providing more program benefits.

Whenever the state chooses to fund its needs by using bonds, the state is making an additional long-term commitment of General Fund monies.

What Are the Trade-offs Associated With Using Bonds?

As discussed above, financing with direct appropriations is less costly than financing with bonds. For example, a project that would cost $100 million with a direct appropriation would cost the state about $129 million if financed with general obligation bonds, and $152 million if financed with lease-payment bonds, after adjusting for inflation.

If it's cheaper to finance capital outlay needs through direct appropriations, why should the state use bonds? Just as most families cannot pay "up front" the cost of a house, the state cannot afford to finance

It is, therefore, critical to weigh the costs and benefits of these long-term investments against the costs and benefits of providing other state services.

many of its assets in such a way. Thus, the use of bond financing allows the state to acquire assets sooner than it otherwise could. In addition, since capital infrastructure generates benefits to citizens over many years, it often makes sense to spread these costs over time among the different beneficiaries.

It is also important to note that, whenever the state chooses to fund its needs by using bonds, the state is making an additional long-term commitment of General Fund monies. For instance, for every $1 billion in general obligation bonds sold, the state is committing to pay about $87 million in annual debt service costs for the next 20 years. Consequently, there is a trade-off between using bonds to fund the state's infrastructure needs and funding the state's ongoing General Fund programs. It is, therefore, critical to weigh the costs and benefits of these long-term investments against the costs and benefits of providing other state services.

WHAT IS THE STATE'S CURRENT AND PROJECTED DEBT BURDEN?

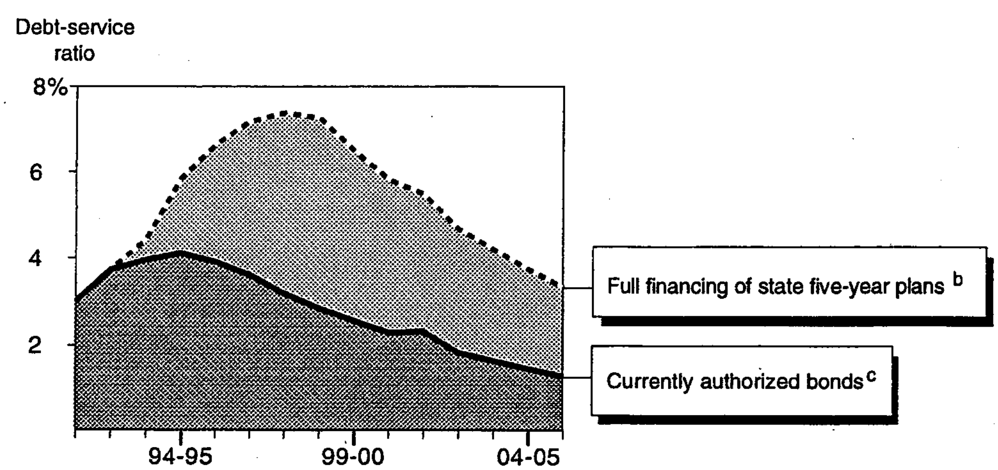
Currently, the amount of debt service paid from the General Fund as a percentage of state General Fund revenues (that is, the state's debt ratio) is still relatively low -- about 3 percent. The debt ratio, however, has risen sharply in recent years, as it was 1.75 percent in 1988-89. In the current year, the state will pay an estimated $1.4 billion in debt service.

Figure 3 shows what would happen to this debt ratio in the future under two scenarios. First, if all currently authorized bonds are sold (but no others are authorized), the state's debt ratio would reach a peak of about 4.1 percent in 1994-95 and decline to 1.3 percent in 2005-06.

Second, the figure shows how the state's debt ratio would increase if identified infrastructure needs are met through additional general obligation

Figure 3

**Projected General Fund Debt-Service Ratio[a]
1991-92 through 2005-06**



[a] Assumes 7.0 percent interest rate on general obligation bonds and 7.5 percent interest on lease-payment bonds. Also assumes 5 percent revenue growth from 1991-92 through 1992-93, and 7.5 percent annual revenue growth from 1993-94 through 2005-06.

[b] Assumes $28.6 billion of new general obligation bond authorizations to meet capital needs from 1992-93 through 1996-97. Assumes no bond authorizations in subsequent years.

[c] Based on State Treasurer's plan for selling currently authorized bonds.

bond financing over the next five years, with no subsequent bond authorizations. We estimate that the state's debt ratio would reach a peak of about 7.5 percent in 1997-98 if general obligation bonds are used to fulfill both the state's and K-12 education's five-year identified infrastructure needs of $28.6 billion. If the state is unwilling to incur a debt ratio of this magnitude, it will have to make some very difficult choices among identified capital needs.

What Effect Will Changes in the State's Credit Rating Have?

The state enjoys the highest ratings possible by the two major rating agencies (Moody's and Fitch). Recently, however, the other major rating agency (Standard and Poor's) reduced the state's credit rating from AAA to AA, citing concerns about the state's budget deficit. A reduced credit rating is likely to have the effect of increasing slightly the interest rate the state pays on future bond issues. The actual effect depends upon investor reaction to the rating change and the market conditions at the time of sale. If, for example, the interest rate increased by 0.25 percent, the state's debt service costs over the life of the bonds would increase by about $3 million for each $100 million in general obligation bonds sold.

Should the State Assume Additional Bond Debt?

Although the state should not indiscriminately place bonds on the ballot, the judicious use of bonds to finance the state's infrastructure priorities can enhance the state's economic health and quality of life for California's citizens. Furthermore, given California's relatively low debt ratio, we believe that, with proper planning and setting of priorities, it may very well be in the state's best interest to take on somewhat higher debt in the near term in order to invest in the state's future. In doing so, however, it is essential that the Legislature use additional debt to finance those areas that are clearly a state responsibility and for which other, less costly alternatives are not available.

In trying to determine how many bonds to place on the ballot in 1992, there is no magic formula that can generate the "right" amount. However, the Legislature should be guided primarily by the expected returns from investing in capital assets and by its perception of the voters' willingness to approve bonds, *not* by arbitrary limits on bond authorizations or the debt ratio.

It is essential that the Legislature use additional debt to finance those areas that are clearly a state responsibility and for which other, less costly alternatives are not available.

WHAT BOND MEASURES ARE BEFORE THE LEGISLATURE?

Early in January, the majority party of each house of the Legislature and the Governor proposed separate general obligation bond programs for the June and November 1992 ballots. Each proposal totaled $6 billion and contained somewhat different individual bond programs. In addition, as of January 6, 1992 there were 29 separate bond measures before the Legislature. Figure 4 summarizes these 29 measures, which total $16.3 billion. (The total without double-counting those measures that fund nearly identical programs is $11.3 billion.) Programmatically, the $16.3 billion is comprised of $6 billion in resources, $5.6 billion in education, $0.8 billion in corrections, and $3.9 billion in "all other."

While the total amount of bonds currently proposed is substantial, the amounts proposed for certain programs would still leave many unmet needs. For example, the $1 billion proposed for higher education (the larger of the two higher education proposals) would fund only about 20 percent of the needs identified in the three higher education segments' five-year plans. Likewise, the $465 million

Figure 4

General Obligation Bonds Proposed for the 1992 Ballots[a]

Bill	Author	Authorization (in millions)	General Program Area
Resources: Water			
AB 24	Filante	$600	Water recycling, pollution control, and conservation; wastewater and toxics cleanup
AB 1387	O'Connell	200	Safe drinking water and drought relief
AB 1800	Peace	150	Wastewater and toxics cleanup
AB 2004	Cortese	200	Water quality and conservation
AB 2024	Costa	50	Water pollution control
AB 2112	Polanco	1,000	Water desalination, safe drinking water, and drought relief
SB 39	Ayala	1,200	Auburn Dam water quality protection
SB 778	Killea	300	Water reclamation and desalination
SB 1087	Thompson	300	Water desalination
Resources: Other			
AB 72	Cortese	678	Heritage lands
AB 1641	Sher	455	Fish and wildlife
SB 387	McCorquodale	305	Heritage lands
SB 710	Mello	263	Coastal and riparian resources
SB 888	Keene	300	Old-growth and native forest protection
Education			
AB 257	Hayden	1,000	Higher education facilities
AB 880	Eastin	2,143	K-12 school facilites (November)
AB 2062	Brulte	800	K-12 school facilities
SB 34	L. Greene	800	K-12 school facilities
SB 119	Hart	900	Higher education facilities
Corrections			
AB 369	Murray	465	State adult and juvenile facilities
SB 269	Presley	300	County juvenile facilities
Other			
AB 1965	Areias	475	Earthquake safety: state and local government buildings
AB 2194	Bates	Unspecified	Child care facilities
SB 593	Roberti	450	Affordable housing
SB 932	Killea	1,500	Local public infrastructure
SB 1106	Watson	50	Child care facilities
SB 1216	Rosenthal	100	Clean fuels (November)
SB 1230	Keene	300	Local libraries
AB 973[b]	Costa	1,000	Rail Transportation (November)
Total, all proposals		**$16,284**	
Total, without double-counting		**$11,261**[c]	

[a] Status of proposals as of January 6, 1992. Proposals are for the June 1992 ballot unless otherwise indicated.
[b] Enacted as Chapter 108, Statutes of 1989.
[c] Excludes authorizations for which another measure exists that calls for a nearly identical program.
Source: Legislative Analyst's Office.

proposed for corrections represents only about 15 percent of the five-year needs. In addition, no bonds are proposed for some state capital programs, such as constructing new state office space, rehabilitating the state developmental centers and hospitals, or upgrading fire fighting/protection facilities.

The proposed bonds also include $7.4 billion for projects that would be developed by entities other than the state, such as cities, school districts, and water authorities. Aside from K-12 education, the needs for these infrastructure programs generally are not well-defined or documented. Thus, it is unclear to what extent the proposed bonds address program needs.

WHAT SHOULD BE CONSIDERED IN DETERMINING WHICH BONDS TO PLACE ON THE BALLOT?

We believe that there are several key factors for the Legislature to consider in making decisions about which bonds to place on the 1992 ballots. These factors are summarized in Figure 5 and discussed below.

Is the Infrastructure Program Urgently Required for Health and/or Safety Purposes? One factor to consider in allocating bonds is whether the funds would address those health and/or safety hazards that are considered the most critical by the Legislature. For example, are there life-threatening situations within the state's 24-hour institutions, or are there identified areas of immediate personal danger within state facilities in the event of an earthquake?

Would There Be Significant Negative Consequences of Failing to Immediately Fund an Infrastructure Program? Another factor to consider is whether the Legislature's most important priorities could be fulfilled if bond funding were not provided for a specific infrastructure program. Could a lack of capital funding for a program have a serious detrimental effect on the state's future competitiveness, economic growth or quality of life? Could a lack of capital funding have a negative effect on the state's ability to accommodate clients within the state's developmental centers and/or mental health hospitals?

Are There Alternative Ways of Meeting Infrastructure Needs? The state could adopt policy changes that reduce the need for infrastructure investment by the state. Such policy changes could include: (1) requiring more intensive use of existing facilities -- for example, increased reliance

Figure 5

Key Considerations in Allocating Bond Authorizations

- Is the infrastructure program urgently required for health and/or safety purposes?
- Would there be significant negative consequences of failing to immediately fund an infrastructure program?
- Are there alternative ways of meeting infrastructure needs?
- Are there authorized bonds that could be used to fund an infrastructure program until 1994?
- How quickly will the expenditure of bond funds need to begin, and how will this spending be spread over time?
- Will funding be available to operate and maintain the capital investments funded through bonds?

Bond authorizations, by themselves, do not result in the improvement of infrastructure. Rather, the improvements occur only after specific projects are identified and planned.

on year-round school operations; (2) reducing "caseload" growth in programs -- for example, by expanding the use of "community corrections"; and (3) shifting funding responsibility for certain infrastructure programs -- such as K-12 schools, libraries, and county jails -- to local governments.

Are There Authorized Bonds That Could Be Used to Fund an Infrastructure Program Until 1994? If available funding is sufficient for an infrastructure program to proceed for the next two years, the Legislature may want to consider not proposing additional bonds for that program on the 1992 ballots.

How Quickly Will the Expenditure of Bond Funds Need to Begin, and How Will This Spending Be Spread Over Time? Bond authorizations, by themselves, do not result in the improvement of infrastructure. Rather, the improvements occur only after specific projects are identified and planned. Thus, the Legislature should have assurance that each bond program can be expeditiously implemented, and that the authorized level of bond funding can be committed to construction contracts within two to three years. Indicators of how soon bond funds will be needed include: (1) the existence of a project-specific plan and (2) the availability of administrative and technical resources to implement the plan in a timely manner. Lacking this assurance, bonds may be authorized for programs that are not in a position to spend bond funds in the near term while, at the same time, important priority programs that *could* use the monies go unfunded or underfunded.

Will Funding Be Available to Operate and Maintain the Capital Investments Funded Through Bonds? Although bond proceeds are used to finance capital projects, the ongoing costs of these investments must be provided through the state's General Fund or special funds, or -- in the case of local projects -- through local funds. These additional ongoing costs of new infrastructure must be balanced against the benefits of the projects and the ongoing needs of other state and local programs. Consequently, it is essential that the Legislature have information on the impact of the capital program on the state's or local government's annual operating budget.

CONCLUSION

The state will have to rely, to a great extent, on bond financing to meet its infrastructure needs, which total tens of billions of dollars over the next decade. In deciding the 1992 bond package, an important consideration is that the use of bond financing requires a long-term commitment of General Fund monies and, thus, entails a trade-off between expenditures for long-term capital investments and ongoing General Fund-supported programs. It is, therefore, essential that bond authorizations be directed to the state's highest priority infrastructure needs. This paper identifies several factors which can help the Legislature in making these decisions. ❖

This Policy Brief was prepared by Lucia Becerra and Charles Nicol, under the supervision of Gerald Beavers. For additional copies, contact the Legislative Analyst's Office, State of California, 925 L Street, Suite 610, Sacramento, CA 95814, (916) 445-2375.