

LAO 
65 YEARS OF SERVICE

2007-08 Analysis

MAJOR ISSUES

Capital Outlay



Legislative Implementation of November 2006 Bond Package

- The infusion of \$43 billion in bond funds authorized at the November 2006 election provides the state with a major opportunity to make infrastructure investments that will last for a generation or more (see page G-13).
- There are 67 pots of money included in the bond package, each with its own purpose. At least two dozen state entities will be involved in implementing some component of the package (see page G-27).
- More than \$18 billion of the funds is allocated to 21 new programs. In designing the framework for these new programs, the Legislature should emphasize long-term benefits and statewide priorities. A program's goals and the criteria for selecting projects should be clearly defined (see page G-22).
- The Legislature can add additional oversight by rejecting the use of continuous appropriations, limiting administrative costs, using special committees and joint hearings, and requiring and reviewing annual reports (see page G-24).
- Limits on staff, materials, and the readiness of high-quality projects will require spending over multiple years (see page G-26).
- To pay off these bonds over the next 30 years, the state will pay an additional \$41 billion in interest. We estimate that the state's debt burden will rise to a peak of 5.6 percent of annual revenues in 2010-11 (see page G-20).

- Of the \$43 billion, the Governor proposes spending \$2.8 billion in 2006-07 and an additional \$8.7 billion in 2007-08. The Governor recently issued an executive order on increasing accountability and public information of the bonds. The Legislature will want to ensure that the audits and Web site called for in the order are strategically implemented to avoid duplicating existing accountability measures (see page G-27).



Governor Proposes Billions in Additional Borrowing

- The Governor proposes \$29 billion in additional general obligation bonds to be put before the voters at the 2008 and 2010 elections. The Governor also proposes \$12 billion in lease-revenue bonds, primarily for corrections and local jails (see page G-10).
- If approved, this additional borrowing would raise the state's debt burden to a peak of 6.1 percent of annual revenues in 2014-15 (see page G-41).



LAO Specific Capital Outlay Recommendations

- Unlike prior years, our reviews of specific capital outlay proposals are included in the various policy chapters of this publication. In particular, we review the Governor's proposals for new prisons and court buildings, resources projects, transportation spending, and higher education facilities. The index (under "Capital Outlay Projects") at the back of the publication also lists the individual projects that we review.

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OVERVIEW

Capital Outlay

T*his section discusses the state's infrastructure funding, primarily for the state's capital outlay program. Capital outlay includes new construction, renovation of existing structures, and acquisition of real property. The 2007-08 Budget Bill proposes total expenditure of about \$2.4 billion for the state's capital outlay program (excluding highway and rail programs).*

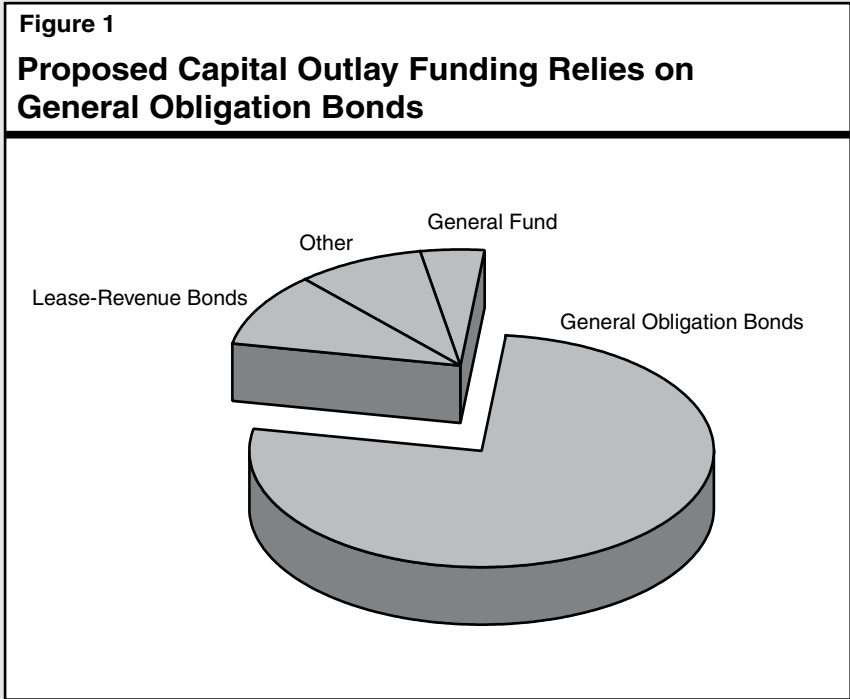
\$43 Billion in Infrastructure Funds Added by Recent Ballot Measures

In November 2006, voters approved a package of five general obligation (GO) bond measures to help address California's aging infrastructure. The measures include \$19.9 billion for transportation, \$2.9 billion for housing, \$10.4 billion for schools, \$4.9 billion for flood control, and \$4.6 billion for resources projects. Most of the bond funds will be allocated to specific projects over the next few years. While the Governor proposes spending \$8.7 billion of the bond proceeds in 2007-08, the majority of the expenditures are in transportation (which are discussed in the "Transportation" chapter of this *Analysis*) and for local schools. The remaining spending is on the state's capital outlay program, encompassing prisons, state office buildings, state hospitals, state parks, and university facilities. (For a detailed analysis of the November infrastructure bonds, please refer to the "Crosscutting Issues" sections of the applicable chapters throughout this publication, including this one.)

The State's 2007-08 Capital Outlay Program

The *2007-08 Budget Bill* proposes \$2.4 billion in state capital outlay funding. This is new funding for continuing phases of existing projects started in previous years, the starting of new projects, and acquisitions of property. (This total does not include billions of dollars of spending from past capital outlay appropriations that is expected to occur in the budget

year. We account for these funds in the years they were appropriated.) Of the \$2.4 billion, over \$1.8 billion—or about three-fourths—is funded from the November bonds. The remaining funding is proposed from the General Fund, lease-revenue bonds, prior-year GO bonds, federal funds, and special funds (primarily the Motor Vehicle Account). Figure 1 shows the distribution of funding proposed in this budget.



Funding by Program

Figure 2 shows the funding amounts proposed in the budget bill for each program. The bulk of the proposed funding is in two areas, higher education and resources. An overview of proposed capital outlay funding is presented below. Unlike prior years, analyses of proposed capital outlay projects are discussed in individual departmental write-ups in each chapter of this publication rather than in this chapter.

Figure 2**New Proposed Capital Outlay Funding in the Budget Bill by Program^a***2007-08
(In Thousands)*

Program	Fund Source				Totals
	General Fund	General Obligation Bonds	Lease-Revenue Bonds	Other	
Higher Education	—	\$1,395,834	\$70,000	—	\$1,465,834
Resources	\$18,752	466,231	147,345	\$20,985	653,313
Corrections and Rehabilitation	73,250	—	10,264	—	83,514
All Other	13,720	7,793	24,212	199,157	244,882
Totals	\$105,722	\$1,869,858	\$251,812	\$220,142	\$2,447,543

^a Does not include highway transportation or K-12 education.

Higher Education. Funding totaling \$1.5 billion (or nearly 60 percent of the total allotted to capital outlay) is divided among the three segments.

- University of California—\$573 million.
- California State University—\$346 million.
- California Community Colleges—\$546 million.

This funding principally comes from GO bonds passed since 1998, as well as \$70 million in lease-revenue bonds. While most of the GO bond funding comes from Proposition 1D passed in November 2006, \$87 million comes from prior bond acts. The budget proposal would allocate most remaining funds from these prior acts and leave approximately \$685 million in Proposition 1D bonds available for future years.

Resources. Proposed funding in resources totals \$653 million.

- Department of Water Resources—\$167 million mainly for flood control.
- Department of Forestry and Fire Protection—\$162 million to replace and relocate various fire stations and facilities.
- Various conservancies and Wildlife Conservation Board—\$127 million for land acquisition.

The balance of the funds are allocated primarily for parks and conservancy projects throughout the state. Bonds fund 94 percent of the proposed resources projects—71 percent from GO bonds and 23 percent from lease-revenue bonds.

Corrections and Rehabilitation. The budget bill proposes capital outlay funding of \$84 million for the Department of Corrections and Rehabilitation. These expenditures are largely for infrastructure projects to address kitchen facilities, cell enhancements, exercise yards, and deficiencies in water and wastewater treatment systems at various correctional institutions. Additional amounts are proposed for the department in the Governor's new bond proposals, which are discussed below.

Governor's New Bond Proposals

The Governor proposes \$43.3 billion in additional bond funding over the next few years to support a variety of infrastructure projects (see Figure 3). The proposal includes \$29.4 billion in GO bonds to be put before the voters in 2008 and 2010. Of this amount, \$23.3 billion would be for education purposes, such as the construction and modernization of K-12 and higher education facilities. The remaining GO bond funds would be mostly allocated to water development projects (\$4 billion) and court facilities (\$2 billion).

Figure 3					
Governor's Proposed Bond Package					
<i>(In Billions)</i>					
	General Obligation		Lease- Revenue	Revenue	Total
	2008 Ballot	2010 Ballot			
K-12 Education	\$6.5	\$5.1	—	—	\$11.6
Higher Education	7.2	4.3	\$0.1	—	11.6
Corrections	—	—	9.5	—	9.5
Flood control/ water supply	4.0	—	—	\$2.0	6.0
Courts	2.0	—	—	—	2.0
Other	0.3	—	2.3	—	2.6
Totals	\$20.0	\$9.4	\$11.9	\$2.0	\$43.3

Additionally, \$13.9 billion in capital infrastructure funding is proposed as lease-revenue and traditional revenue bonds. The Governor's bond plan for prison reform, in response to overcrowding and medical treatment issues, makes up the most of this amount with a proposal to fund \$9.5 billion in new capital outlay projects. Figure 4 shows how this funding (along with \$300 million from the General Fund) would be allocated. It is anticipated that this funding would be spent over multiple years.

Figure 4	
Governor's Proposed Prison Capital Outlay Funding	
<i>(In Billions)</i>	
Program Element	Funding
Local Jail and Juvenile Offender Capacity	\$4.4
Infill Housing and Program Space	2.7 ^a
Community-Based Reentry Facilities	1.6
Health Care Infrastructure Driven by Litigation	1.0
San Quentin Condemned Inmate Complex	0.1
Total	\$9.8
^a Includes \$300 million from the General Fund.	

The remaining components of the borrowing plan are to provide \$2 billion for water development projects and \$2.3 billion for a variety of state projects (including forestry and fire protection, mental health facilities, seismic retrofit of state facilities, state special schools for the blind and deaf, and a DNA laboratory).

Awaiting Infrastructure Plan Update

Chapter 606, Statutes of 1999 (AB 1473, Hertzberg), requires the Governor to annually submit to the Legislature a five-year infrastructure plan in January in conjunction with the submission of the Governor's budget. The plan is required to identify new and renovated infrastructure requested by state agencies (including higher education), and aggregate funding for transportation and K-12 education. Additionally, the plan is required to provide a cost estimate and a specific funding source for the infrastructure projects identified. Thus, the plan represents the administration's funding priorities for infrastructure improvements across all departments and programs.

Plan Not Submitted on Time. The administration did not submit a 2007 infrastructure plan as required in January. Instead, the administration reports that it plans to submit it on March 1, 2007. The 2007 plan is expected to incorporate (1) the availability of the \$43 billion in GO bonds from November 2006, (2) the Governor's prison capital outlay program, (3) the Governor's proposals to place an additional \$29 billion in GO bonds before the voters in 2008 and 2010, and (4) the Governor's other proposals.

Debt Service on Infrastructure Bonds

For those infrastructure projects that are funded through bonds, the state must make annual debt-service payments to retire the bonds. Most of these payments are to cover infrastructure projects that were completed in prior years. We estimate that the total infrastructure debt-service payments from the General Fund will be \$4.7 billion in 2007-08. In the "Crosscutting Issues" section of this chapter, we discuss the payments in more detail and how they will be affected by the passage of the November 2006 bond package.

CROSSCUTTING ISSUES

Capital Outlay

IMPLEMENTING THE 2006 BOND PACKAGE

This piece is largely based on the “Overview” section of our January 2007 report titled, Implementing the 2006 Bond Package. It has been updated to include new data on the affordability of the bonds and to comment on the Governor’s recent executive order related to the bonds.

In November 2006, California voters approved five propositions which authorize \$42.7 billion in general obligation (GO) bonds. The bonds cover a range of purposes, including transportation, education, resources, and housing. The bond package represents a major commitment by the Legislature, Governor, and the voters to improve the state’s infrastructure.

The large infusion of bond proceeds provides the state with a major opportunity to make infrastructure investments that will last for a generation or more. At the same time, in overseeing the implementation of the bonds, the Legislature faces several challenges. The bonds provide funding to many new programs for which goals and allocation criteria have yet to be established. The way in which these programs are crafted by the Legislature will help determine the level of the bonds’ success. In addition, ongoing legislative oversight of all of the funding would increase accountability and increase the likelihood of positive outcomes. This report aims to assist the Legislature in implementing the 2006 bond package. It offers key considerations and recommendations to the Legislature to help ensure the bond proceeds are used effectively and efficiently.

This piece provides an overview of the bonds, the programs funded, and their long-term financing costs. It also broadly summarizes the Governor’s proposals for implementing the bonds. Finally, we discuss key implementation issues that cut across more than one of the bonds.

For a more detailed discussion regarding individual bonds, please see the policy-specific chapters of this publication.

THE BOND PACKAGE

The 2006 bond package approved by the voters in November provides \$42.7 billion for infrastructure spending. The package included five propositions spanning transportation (Proposition 1B), housing (Proposition 1C), education (Proposition 1D), and resources (Propositions 1E and 84).

Interest Costs. As GO bonds, the spending authorized will need to be paid back, with interest, from the state's General Fund over time. In recent years, GO bonds have been paid off over a 30-year period. Since they are backed by the state's general taxing power and generally exempt from taxation under federal law, the bonds tend to be sold with the lowest interest rate compared to other types of borrowing. In the voter information guide for the November 2006 election, we assumed most of the bonds would be sold at an average interest rate of 5 percent. (Proposition 1C, the housing bond, will have higher interest rates since a portion of the bonds are not eligible for the federal tax exemption.) Figure 1 summarizes the five bonds and the interest payments that we estimate will be made over the life of the bonds. The interest payments will almost double the costs of the bonds over their life—for a total cost of \$84 billion.

Many Pots of Money. Within the five bond measures, there are many specified allocations of funds. In total, there are 67 pots of money included in the five bonds. The smallest such pot of money is in the housing bond and provides \$10 million for self-help construction grants to organizations

Figure 1

Long-Term Costs of the 2006 Bond Package^a

(In Billions)

	Principal	Interest	Totals
Proposition 1B—Transportation	\$19.9	\$19.0	\$38.9
Proposition 1C—Housing	2.9	3.3	6.2
Proposition 1D—Education	10.4	9.9	20.3
Proposition 1E—Flood Control	4.1	3.9	8.0
Proposition 84—Resources	5.4	5.1	10.5
Totals	\$42.7	\$41.2	\$83.9

^a LAO state voter pamphlet estimates, November 2006.

which assist households in building or renovating their own homes. In contrast, the largest pot of money is in the transportation bond and provides \$4.5 billion for corridor mobility to reduce congestion on state highways and major access routes. Each pot of money has its own purpose, administering department, and restrictions (if any) on its use. Many different state departments will be involved in the implementation and allocation of the bonds. Figure 2 summarizes the broad categories of funding within each bond. In each of the individual program area write-ups later in this report, there is a figure which provides a description of each of the 67 pots of funds.

Figure 2	
Allocations of 2006 Bond Package	
<i>(In Millions)</i>	
Program	Funding
Proposition 1B—Transportation	\$19,925
Congestion Reduction, Highway and Local Road Improvements	\$11,250
Transit	4,000
Goods Movement and Air Quality	3,200
Safety and Security	1,475
Proposition 1C—Housing	\$2,850
Development Programs	\$1,350
Homeownership Programs	625
Multifamily Housing Programs	590
Other Housing Programs	285
Proposition 1D—Education	\$10,416
K-12	\$7,329
Higher Education	3,087
Proposition 1E—Flood Control	\$4,090
Proposition 84—Resources	\$5,388
Water Quality	\$1,525
Protection of Rivers, Lakes, and Streams	928
Flood Control	800
Sustainable Communities and Climate Change Reduction	580
Protection of Beaches, Bays, and Coastal Waters	540
Parks and Natural Education Facilities	500
Forest and Wildlife Conservation	450
Statewide Water Planning	65
Total	\$42,669

Existing Versus New Programs. Some pots of funding provide state programs with additional resources. Many of these existing programs also have funds remaining from prior bond authorizations. In total, we estimate that almost \$5 billion in prior bond funds have not yet been spent on these programs. (As noted in our K-12 discussion, there is an additional \$4 billion available for an overcrowded schools program that was replaced with a new program in Proposition 1D.) In other cases, a pot provides dollars for a purpose never previously funded. In these cases, the program purpose at this point may be defined only by a few sentences. As shown in Figure 3, the bond package funds 21 new programs, representing more than 40 percent of total funding. Many of these new programs will need further implementing legislation in order to begin operating.

Figure 3		
2006 Bond Package Funds Existing and New Programs		
<i>(Dollars in Billions)</i>		
	Number	Funding
Existing programs	46	\$24.5
New programs	21	18.2
Totals	67	\$42.7

Appropriations. Most of the programs will need future legislative action to appropriate funding—either through the annual budget bill or separate legislation—before state departments can begin spending the funds. In some cases, the funds are continuously appropriated—meaning that funding obligations can be made by departments without additional legislative action. These continuous appropriations cover \$9.4 billion of the bond funding. They apply to all K-12 education programs, a number of housing programs, and several pots within Proposition 84.

GOVERNOR’S PROPOSAL

In this section, we provide an overview of the Governor’s approach to implementing the 2006 bond package, as outlined in the Governor’s proposed 2007-08 budget.

Proposed Expenditures for 2006-07 and 2007-08

As shown in Figure 4 (see next page), the Governor is proposing to spend \$11.5 billion of the bond funds by the end of 2007-08—or slightly more than one-quarter of the total available. Of this proposed spending, roughly \$8.9 billion would be used for existing programs while \$2.6 billion would be for new programs.

Current-Year Expenditures. Of the Governor's proposed expenditures, \$2.8 billion would be spent in the current year. In the case of the \$1.1 billion for higher education, the Legislature appropriated these amounts in the *2006-07 Budget Act*, with the assumption that Proposition 1D would be passed by the voters. In other cases, such as the \$985 million for K-12 education facilities, \$160 million for existing housing programs, and \$60 million from Proposition 84, the funding is continuously appropriated and became available for spending upon the passage of the bonds. Regarding the \$523 million in proposed transportation spending for the current year, however, the Legislature would need to enact urgency legislation to appropriate the funds if it wished to adopt the administration's planned timing.

Budget-Year Expenditures. The Governor proposes spending \$8.7 billion in 2007-08. In some cases, the administration proposes new staffing and statutory language to help implement the programs. In other cases, however, the Governor's budget does not include any such requests despite a program being funded for the first time. While this proposed spending covers most of the programs authorized by the bond package, the Governor's plan does not include spending for seven pots of funding, primarily for new programs.

Bond Package in the Context of the State Infrastructure Plan

Five-Year Plan Required. Chapter 606, Statutes of 1999 (AB 1473, Hertzberg), requires the Governor to annually submit to the Legislature a five-year infrastructure plan in January in conjunction with the submission of the Governor's budget. The plan is required to identify new and renovated infrastructure requested by state agencies (including higher education), and aggregate funding for transportation and K-12 education. Additionally, the plan is required to provide a cost estimate and a specific funding source for the infrastructure projects identified. Thus, the plan represents the administration's funding priorities for infrastructure improvements across all departments and programs.

Plan Not Submitted on Time. The administration did not submit a 2007 infrastructure plan this month. Instead, the administration reports that it plans to submit it on March 1, 2007. As such, it is difficult to assess precisely how the \$43 billion bond package meets the state's current over-

all infrastructure needs from the administration's perspective. However, the administration's 2006 plan identified total state infrastructure costs of \$90 billion through 2010-11. Clearly, the 2006 bond package significantly increases the amount of funding available to address that \$90 billion

Figure 4

Governor's Proposed Spending Plan for 2006 Bond Package

(In Millions)

Program	2006-07	2007-08	Future Years
Proposition 1B—Transportation			
Congestion reduction, highway and local road improvements	\$503	\$1,858	\$8,889
Transit	—	600	3,400
Goods movement and air quality	15	267	2,918
Safety and security	5	64	1,406
Proposition 1C—Housing			
Development programs	—	\$228	\$1,122
Homeownership programs	\$35	129	461
Multifamily housing programs	105	236	249
Other housing programs	20	67	198
Proposition 1D—Education			
K-12	\$985	\$2,142	\$4,202
Higher Education	1,056	1,359	672
Proposition 1E—Flood Control			
	—	\$624	\$3,466
Proposition 84—Resources			
Water quality	—	\$263	\$1,262
Protection of rivers, lakes, and streams	—	245	683
Flood control	—	276	524
Sustainable communities and climate change reduction	—	31	549
Protection of beaches, bays, and coastal waters	—	131	409
Parks and natural education facilities	—	25	475
Forest and wildlife conservation	\$60	119	271
Statewide water planning	—	15	50
Totals	\$2,784	\$8,679	\$31,206

total. Yet, the two numbers are not directly comparable. The bond package funds a number of programs and purposes not envisioned within the administration's five-year plan. For instance, the entire \$2.9 billion in spending authorized by the housing bond was not identified as a state priority by the administration last year.

Governor Proposes Additional Borrowing. While the 2006 bond package made a sizable commitment to the state's infrastructure, it did not address all aspects of the state's infrastructure demands. For instance, the package contained no funding in the criminal justice area. In addition, areas that were funded by the bonds have identified additional demands. For example, Proposition 1D funds for education are expected to fund programs through only 2008-09. In recognition of these limitations, the Governor has proposed additional long-term borrowing as part of his 2007-08 budget package (presented as a second phase to his Strategic Growth Plan). The Governor proposes additional GO bonds totaling \$29.4 billion to be put before the voters in 2008 and 2010 (see Figure 5). Of this amount, the vast majority—\$23.1 billion—would be for education purposes. Education funding would be split about evenly between K-12 and higher education programs. Most of the remaining funds would be for water development projects (\$4 billion) and court facilities (\$2 billion). In addition, the Governor proposes the use of lease-revenue bonds totaling \$11.9 billion—primarily for corrections and local jails. As with GO bonds, costs for lease-revenue bonds are paid off with General Fund revenues.

Figure 5

Approved and Proposed General Obligation Bonds

*2006 Through 2010
(In Billions)*

	Approved 2006	Proposed 2008 and 2010	Totals
Transportation	\$19.9	—	\$19.9
K-12 Education	7.3	\$11.6	18.9
Higher Education	3.1	11.5	14.6
Flood control and water Resources	4.9	4.0	8.9
Housing	4.6	—	4.6
Courts and other	2.9	—	2.9
	—	2.3	2.3
Totals	\$42.7	\$29.4	\$72.1

ISSUES FOR LEGISLATIVE CONSIDERATION

Below, we raise a number of issues that the Legislature will need to consider as it makes its decisions this year regarding implementing the bond package.

Costs and Affordability of the Bonds

Bond Costs and the Budget. Faced with ongoing budget shortfalls, as well as the administration's proposals for additional borrowing, the Legislature will want to consider how infrastructure borrowing fits into the state's budget plan. The cost of the 2006 bond package in the next few years-and its impact on the state's budget-will depend primarily on the timing of bond sales, bond maturity structures, and the bonds' interest rates. In turn, the overall affordability of the package will depend on how its costs affect the state's future debt-service expenses-including costs for bonds that have already been sold, yet-to-be-sold bonds authorized prior to the November 2006 election, and any future bond authorizations. For example, in addition to the 2006 bond package, the state currently has about \$38 billion of GO bonds and \$8 billion of lease-revenue bonds outstanding on which it is making principal and interest payments, and another \$25 billion in unsold GO bonds that voters have already approved for various purposes.

Key Assumptions. Our cost projections are generally based on the administration's assumptions about the timing of bond sales. These assumptions suggest annual bond sales from all authorizations totaling over \$10 billion in 2007-08, rising to a peak of nearly \$16 billion in 2009-10. Our projections also assume:

- Maximum maturity lengths for GO bonds and lease-revenue bonds of 30 years and 25 years, respectively.
- GO bond interest rates of 4.5 percent currently, trending up over time to 5.7 percent, with lease-revenue bonds slightly higher.

Debt-Service Amounts. We currently estimate that the state's annual debt-service costs for infrastructure-related debt outside of the November 2006 package amounted to \$3.9 billion in 2005-06, and will be \$4.1 billion in 2006-07 and \$4.6 billion in 2007-08. These costs will peak at \$5.4 billion in 2010-11 as additional already-authorized bonds are marketed, and then decline slowly thereafter as the bonds are paid off over their lifetime. When the bonds approved in November are included, total annual debt service is projected to rise from \$4.7 billion in 2007-08 to a peak of \$7.5 bil-

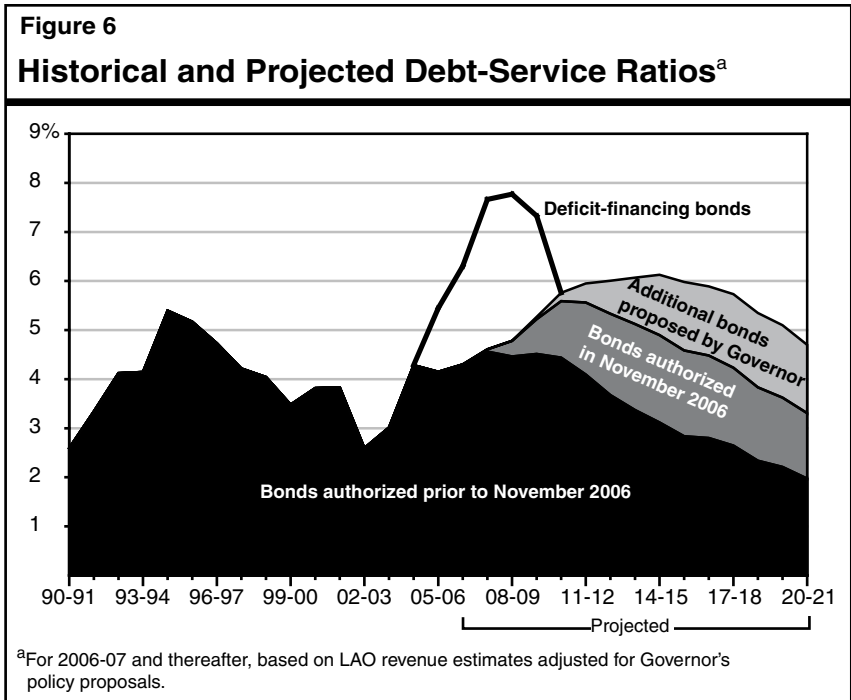
lion in 2014-15. Finally, when the additional GO and lease-revenue bonds proposed by the administration are included, debt service would peak at \$10.4 billion in 2017-18.

Debt-Service Ratio (DSR). The ratio of annual debt-service costs to yearly revenues is often used as a general indicator of a state's debt burden. The DSR helps to look at debt from the perspective of affordability, as it takes into account the amount of revenues the state has available or is projected to have available to fund its programs (including debt payments).

Although concerns have sometimes been voiced in the past about DSRs in excess of 5 percent or 6 percent, there is no "right" level for the DSR. Rather, this depends on such things as a state's preferences for infrastructure versus other priorities, and its overall budgetary condition. Some states, for example, have comparatively high DSRs and/or related measures (such as debt as a percent of personal income) that are higher than California's, but still experience more favorable bond ratings. Examples include Maryland, New York, New Jersey, and Illinois.

From an affordability perspective, however, each additional dollar of debt service out of a given amount of revenues comes at the expense of a dollar that could be allocated to some other program area. Thus, the "affordability" of more bonds has to be considered not just in terms of their marketability and the DSR, but also whether their dollar amount of debt service can be accommodated on both a near- and long-term basis within the state budget. (As a rule of thumb, each \$1 billion of new bonds sold at 5 percent interest adds close to \$65 million annually to state debt-service costs for as long as 30 years.)

LAO Debt-Service Projections. Figure 6 (see next page) shows California's DSR in recent years and its projected outlook for the future. The DSR was well under 2 percent during most of the post- World War II period, increased in the early 1990s when it peaked at somewhat over 5 percent, and then fell below 3 percent in the early 2000s. It has since risen as new bond authorizations have been sold, and would peak at 4.6 percent in 2007-08 without the November 2006 bonds. Including the November bonds, the DSR is projected to peak at 5.6 percent in 2010-11. Finally, including the new GO and lease-revenue bonds proposed in the Governor's budget, the DSR would peak at 6.1 percent in 2014-15. On top of these amounts are the payments the state is making on the deficit-financing bonds (Proposition 57) that were issued to help address the state's ongoing budget problems, and which the administration is proposing to pay off during 2009-10.



Ensuring Adequate Legislative Oversight and Accountability

The Legislature's role in implementing the bond package is to provide:

- A statutory framework to effectively administer and distribute the funds.
- Appropriations of the funds.
- Oversight to ensure the programs are then administered in accordance with the Legislature's and the voters' intent.

This legislative role can help ensure that the \$43 billion infusion of funding to the state is implemented with accountability and transparency.

Developing New Programs. Since the bonds commit \$18.2 billion to new programs, one of the most important tasks for the Legislature will be to effectively design the frameworks for these new programs. Figure 7 lists each of the 21 new programs.

Figure 7	
Many New Programs Funded by 2006 Bond Package	
<i>(In Millions)</i>	
Program	Funds
Proposition 1B—Transportation	
Corridor mobility	\$4,500
Local transit	3,600
Trade corridors	2,000
Highway 99	1,000
State-Local Partnership grants	1,000
Air quality	1,000
Transit security	1,000
School bus retrofit	200
Port security	100
Proposition 1C—Housing	
Development in urban areas	\$850
Development near public transportation	300
Parks	200
Pilot programs	100
Homeless youth	50
Proposition 1D—Education	
Severely overcrowded schools	\$1,000
Career technical facilities	500
Environment-friendly projects	100
Proposition 84—Resources	
Local and regional parks	\$400
San Joaquin River restoration	100
Urban water and energy conservation	90
Incentives for conservation planning	90
Total Funding	\$18,180

- Long-Term Benefit.* Current law essentially requires that GO bonds be used only for capital purposes which have a long-term life. The principle behind this law is that the state should not conduct long-term borrowing for costs that only provide short-term benefits, such as day-to-day maintenance or operations costs. If, instead, bond proceeds were used for short-term benefits, it would mean that taxpayers three decades from now would be paying for

the short-term benefits enjoyed by today's California residents. In developing new programs, we recommend that the Legislature strongly enforce the principle that bond proceeds should only support projects that will provide a long-term benefit to the state.

- **Criteria and Priorities.** Another important consideration in establishing a new program is to ensure that the funding will reflect statewide priorities. The best way to accomplish this goal is to lay out in state law the program's goals and the criteria for selecting projects which meet those goals. By defining who is eligible for the funds and what are the program's priorities, grant recipients will have a fair opportunity to compete for funding. After allocations are made, the Legislature can use these statutory criteria to verify that the administering state department's process met legislative priorities.

Appropriations. The "power of the purse"-appropriation authority is one of the Legislature's most powerful tools to ensure accountability. Without an appropriation, the administration cannot spend bond funds. Therefore, the Legislature should not appropriate funds until it is satisfied that the administration will spend them effectively. On the other hand, continuous appropriations provide minimal opportunities to ensure legislative oversight. Departments can spend continuously appropriated funds without any further action by the Legislature. While continuous appropriations may be appropriate in some circumstances, we recommend that the Legislature not add any new continuous appropriations to the bond programs. In addition, a continuous appropriation does not preclude the Legislature from instead including the appropriation in the budget bill "in lieu" of the continuous appropriation. We recommend, for example, that the Legislature take this approach for Proposition 84 programs with continuous appropriations.

Limiting Administrative Costs. Each dollar spent on administrative costs within a bond program is one less dollar that is available for infrastructure projects. The Legislature therefore should make every effort to ensure that administrative costs are contained to the greatest extent possible. By actively reviewing requests from the executive branch for staff and other administrative costs, the Legislature likely can increase the funds available for grants and projects. We have recommended in the past that no more than 5 percent of a program's funding should go towards administrative costs in the resources and housing areas. That level of administrative funding for competitive grant programs is typically sufficient to provide enough state staff to effectively manage a program. (A strict cap on administrative costs may not make sense in every program area, particularly in those areas where the state is responsible for designing and

constructing capital outlay projects such as the California Department of Transportation [Caltrans].)

Using Special Committees and Reporting. In the past, the Legislature has performed effective oversight of bond and other programs through the use of joint committee hearings and annual reporting requirements. For instance, by holding a hearing that merges both budget and policy committee members and staff (from one house or jointly between the Assembly and Senate), the Legislature may be better able to assess the full fiscal and policy implications of not only its decisions but also those of the administering entities. Similarly, annual reports from state departments can allow the Legislature to monitor the administration's progress in achieving specific program objectives. Later in this report, we provide specific recommendations in areas where we think these techniques would be effective.

Infrastructure planning and financing is a complex issue because it is related to so many state functions and involves a long-term vision for the state. We have also recommended in the past that the Legislature establish special committees to deal with infrastructure and capital outlay issues. Looking beyond the 2006 bond package, a special policy or joint committee could assist the Legislature in focusing on the state's long-term infrastructure planning. Such a committee could help the Legislature review the administration's 2007 five-year plan and the Governor's latest proposals for additional infrastructure borrowing.

Economic Impacts of the Bond Package

State expenditures on infrastructure can have important positive impacts on the economy in terms of employment, gross state product, and the various components of the tax base, such as personal income, corporate profits, and taxable sales. This is especially true to the extent that California is the origin of the various intermediate materials and supplies used in construction activities. In addition, infrastructure projects themselves can generate significant economic benefits, such as improved transportation networks that facilitate the movement of people and products, flood control projects which enhance property values and make new geographic areas available for business and residential uses, and school facilities that help produce a more educated labor force that in turn eventually enhances economic productivity.

Yet, while the magnitude of the 2006 bond package is substantial, it is only a fraction of the size of the overall economy and construction sector in California. For example, in the near term, the state's gross domestic product is expected to be about \$1.7 trillion and the combined statewide value of residential and nonresidential new building permits is roughly

\$70 billion (with probably two or three times that amount being the overall contribution of the building sector to the state's economy once all of the indirect and induced economic activity associated with construction-related activity is considered). In addition, not all of the bond package represents a net increase in infrastructure funding compared to that which would have occurred without the package. Californians have typically passed individual new bond authorizations fairly regularly in past years. Thus, while the bond spending can be expected to have a substantial positive dollar economic impact, its magnitude will probably be modest in the context of the overall economy.

Timing Considerations

In evaluating the Governor's proposals and developing its own funding schedule, the Legislature will need to balance several factors related to the timing of spending. Of course, there will be a desire to get the newly authorized funding appropriated and distributed quickly. This desire should be balanced with practical considerations that limit the state's ability to effectively spend the funds in a short time period. In some cases, the Legislature may need to prioritize among the various infrastructure demands.

Personnel and Materials. As the Legislature considers the large level of new resources available from the bonds, it will need to determine the limits of capacity for state personnel to manage the expansion of programs. Particularly in the short term, the state may be unable to recruit, hire, and train a sufficient number of staff in some programs to accommodate a rapid rise in spending. If the work is for architectural or engineering services, the Legislature could make expanded use of contracted services, as permitted by Article XXII of the State Constitution. For instance in the case of Caltrans, without additional contracting out, the department may have to hire as many as 4800 new staff to deliver projects funded by Proposition 1B.

Another similar factor to consider is the effect of billions of dollars of public works projects on the costs of construction crews and materials. In recent years, the state (as well as other governments and private builders) have struggled with rapidly rising construction costs driven by limited supplies of trades workers and construction materials. For example, the cost of concrete has climbed sharply and has added significant costs to many projects. To the extent that the state funds projects more evenly over time, it may be able to partially mitigate this trend.

Quality of Projects. There is also tension between timing of projects and their quality. From past experience, spreading allocations over several funding cycles would likely improve the overall quality of the projects

funded through competitive programs. To the extent that more funds are awarded in any given year for a competitive grant program, for instance, lower-score projects would tend to be funded. By spreading the dollars out, there is more time for higher-quality projects to be put together and submit applications. For example, this longer-term approach is proposed by the administration for the ongoing housing programs (as was the case with previous housing bonds).

Coordination Among State Entities Needed

As shown in Figure 8 (see next page), at least two dozen state entities will be involved in implementing some component of the 2006 bond package. Throughout the package, there are program allocations for purposes that cut across traditional state departmental boundaries. One of the key roles for the Legislature will be ensuring that departments are communicating and coordinating with each other when appropriate. For instance, the new development programs within the housing bond aim to promote urban development, particularly near public transportation. At the same time, the transportation bond provides billions of dollars for transit improvements. As such, without close coordination among the departments administering these funds, the state may miss an opportunity to make both sets of money go further by linking projects and/or timelines. Likewise, both the housing and resources bonds contain funding for parks. While conceivably the state could operate distinct park grant programs in two departments, designating a single department (such as the Department of Parks and Recreation [DPR]) to act as the primary administrator of all park bond funds would likely result in lower administrative costs and more consistent project evaluation.

In these instances, the Legislature can take a number of steps to ensure that proper coordination and planning between departments is taking place. Holding hearings that cut across traditional program areas, requiring joint implementation plans, and verifying implementation progress are a few of the approaches available to the Legislature.

Details Still Forthcoming on Executive Order for Accountability

Governor's Executive Order. On January 24, 2007, the Governor signed an executive order with the intent of increasing governmental accountability and public information about the use of the November 2006 bonds. The Governor's executive order focuses on three main areas.

- *Prior to Spending.* For each bond funded program, a department is required to delineate the criteria or processes for spending the funds. The criteria and processes would be based on one or more of the following: existing law and regulations, strategic plans,

capital outlay programs, and performance standards or outcome measures.

- **While Spending.** Departments would report semiannually to the Department of Finance (DOF) on what actions they are taking to ensure that costs are controlled and funds are spent as allocated.
- **After Spending.** Expenditures would be subject to audits by DOF staff (unless alternative audit measures are approved by DOF).

Figure 8**2006 Bond Implementation
Will Involve Many State Entities**

- Air Resources Board
- California Conservation Corps
- California Community Colleges
- California Housing Finance Agency
- California School Finance Authority
- California State University
- California Transportation Commission
- California Department of Transportation
- Department of Education
- Department of Fish and Game
- Department of Health Services
- Department of Housing and Community Development
- Department of Parks and Recreation
- Department of Water Resources
- Division of State Architect
- Ocean Protection Council
- Office of Emergency Services
- Office of Public School Construction
- Resources Agency
- State Allocation Board
- State Conservancies (nine)
- State Water Resources Control Board
- University of California
- Wildlife Conservation Board

Plans Due March 1, 2007. Each department has until March 1, 2007 to develop its accountability structure consistent with the executive order. Departmental plans must be approved by DOF prior to the expenditure of bond funds, unless DOF provides an exception.

Public Web Site. The DOF is required to develop and maintain a Web site that contains information provided by each department; including:

- Each department's accountability and outcome measures.
- Project listings, with the amount of funds allocated to each project.

Laudable Purpose. As described elsewhere in this write-up, the goal of the executive order—to increase accountability and transparency—is commendable. The emphasis on measuring a program's performance would assist the Legislature in its efforts to ensure that programs are meeting their stated purpose. Similarly, an up-to-date Web site would provide the Legislature and the public much of the information we recommend that departments provide.

Many Implementation Questions. At the time this analysis was prepared, the administration could not provide many implementation details about the executive order. If implemented strategically, the order could increase the effectiveness of the bond program. If, however, the order is implemented uniformly without regard for specific programs and their existing accountability measures, it could create an unnecessary level of paperwork that slows projects down while increasing costs.

- **Audits.** The bond package will fund thousands of projects, loans, and grants. Currently, every public works project is subject to audit. Audits typically consist of verifying that programs adhere to laws, regulations, policies, and financial controls. In many cases, the bond programs already have auditing programs in place. For instance, Proposition 1C requires the Bureau of State Audits to conduct periodic audits of housing projects. The executive order reemphasizes that all expenditures of bond proceeds are subject to audits. The executive order's language is unclear as to the administration's plans for the magnitude and scope of audits to be required.
- **Web Site.** Currently, information on bond-funded programs is not centrally available. The many departments that administer the programs each have their own approach to presenting information. A central repository, therefore, has appeal. The DOF, however, will have to spend a considerable amount of time developing and maintaining such a site—given the volume of information that will have to be posted and new reporting formats and systems that will have to be developed. Moreover, such a site would only

add significant value if it is regularly updated and maintained with accurate information. In addition, the format and consistency of how the information is presented would be a major factor in determining its usefulness to the Legislature.

Additional Resources? To date, the administration has not identified how many additional audits it will seek above those already scheduled to occur. The development of a useful Web site may require a substantial investment of time and money by DOF. Assuming that these activities would be funded from the bond proceeds, they would reduce the amount available for projects. As such, the Legislature will want to balance accountability and transparency with timely delivery of infrastructure projects.

Rethinking Labor Compliance Programs (LCPs)

As described below, the Legislature has dedicated considerable resources from past bonds to increase enforcement of the state's labor wage laws. In implementing the 2006 bond package, the Legislature again will face decisions about which approach to take in this area.

California's Prevailing Wage Law and LCPs. The state's prevailing wage law affects most state and local public works projects, including most projects funded by the 2006 bond package. While the Department of Industrial Relations (DIR) is the primary state entity responsible for enforcing the law, the Legislature in recent years has required LCPs to supplement the work of DIR for some bond acts. Using a portion of bond proceeds, LCPs are supposed to educate contractors and subcontractors about wage laws and review and audit payroll records to verify compliance. About 80 percent of LCPs are operated by school districts, with most of the rest operated by third-party contractors.

LCP Reporting and Accountability Appears Weak. Our review of summary data from annual reports filed with DIR by LCPs suggest that the amount of wages recovered for workers by the LCPs—as well as penalties imposed for violations of wage laws—is minor, given the volume of public works contracts that LCPs monitor and the amount spent on administering LCPs. Despite LCPs having a primary role in enforcing compliance for contracts totaling \$8.3 billion between 2003 and March 2006 (primarily for education construction), the reports show that the programs only recovered somewhere around \$3 million or \$4 million of wages, penalties, and forfeitures related to their wage enforcement activities. The LCPs spent about \$70 million of state GO bond proceeds and local matching funds during this period. In other words, LCPs spent between \$18 and \$23 for each \$1 of wages, penalties, and forfeitures they report to have recovered. At the same time, these measures of wage recovery activity do not capture

any voluntary compliance or reduction of complaints to DIR that may be the result of LCPs' work.

Legislative Options for Enforcing Prevailing Wage Laws. As discussed earlier, each dollar spent on administrative costs within a bond program is one less dollar that is available for infrastructure projects. In this instance, the \$70 million in LCP spending would have been able to fund about 200 new classrooms if it had instead been directed to construction. Because there is weak evidence concerning the effectiveness of LCPs, we recommend that the Legislature consider other options for future prevailing wage enforcement activity, including projects funded by the 2006 bond acts.

- **Stronger Oversight of LCPs and a Sunset Date.** If the Legislature wishes to extend LCP requirements to 2006 bond act projects, we recommend that it pass legislation requiring DIR to strengthen its oversight of LCPs. More accurate and detailed reporting, the revocation of poor-performing LCPs' authorizations, and improved training would increase the likelihood of LCPs effectiveness. In addition, any new authorizations for LCPs should include a sunset date (such as December 31, 2008) to allow for a thorough review of their work.
- **Increase DIR Enforcement Staff Instead of New LCP Requirements.** As an alternative to LCP requirements, the Legislature could expand DIR's enforcement staff by authorizing the establishment of new positions. An increase in staffing also should be accompanied by specific reporting requirements on the staff's productivity.

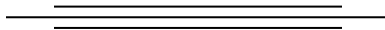
Instead of these options, the Legislature could choose to not authorize any LCPs for the 2006 bond package while maintaining DIR's enforcement staff that monitors public works projects at current levels (numbering 22). With the same number of staff and a rising number of public works projects, however, this would tend to reduce the level of enforcement possible per project.

CONCLUSION

The 2006 bond package represents a major opportunity for the Legislature to address many of the state's most pressing infrastructure concerns. To use the bond funds most effectively and strategically, the Legislature will need to take steps to exercise its oversight role. We lay out a number of key considerations and recommendations to help the Legislature achieve that purpose. These key issues are summarized in Figure 9 (see next page).

Figure 9**Summary of Key Issues in
Implementing the 2006 Bond Package****Overall**

- ✓ Consider how the costs of repaying the bonds fit into the state's overall budget plan.
- ✓ In developing new programs, bond proceeds should only support projects that will provide a long-term benefit.
- ✓ Establish program goals and project selection criteria that reflect statewide priorities.
- ✓ Do not add any new continuous appropriations.
- ✓ Generally limit administrative costs in competitive programs to 5 percent.
- ✓ Use special legislative committees and departmental reports to fully assess policy and budget implications.
- ✓ Recognize bond spending will only have a modest effect on the overall state economy.
- ✓ Balance desire to distribute funds quickly with practical limits on staffing and materials costs.
- ✓ Ensure proper coordination and planning between departments.
- ✓ Ensure that audits and public Web site are strategically implemented to avoid duplicating existing accountability measures.
- ✓ Consider other options besides labor compliance programs to enforce wage laws.



FREQUENTLY ASKED QUESTIONS ABOUT BOND FINANCING

As discussed elsewhere in this chapter, the voters recently approved \$43 billion in bonds and the Governor proposes a like amount over the next few years in additional bond spending. This piece answers basic questions about the state's use of bonds to finance its infrastructure.

What Exactly Is Bond Financing?

Bond financing is a type of long-term borrowing that state and local governments frequently use to raise money, primarily for long-lived infrastructure assets. They obtain this money by selling bonds to investors. In exchange, they promise to repay this money, with interest, according to specified schedules. The interest the state has to pay investors on the bonds it issues for public infrastructure is exempt from their federal and state income taxes, which makes the state's interest cost on the bonds less than it otherwise would be.

Why Are Bonds Used?

As noted above, the state often uses bonds to finance its major capital outlay projects such as educational facilities, prisons, parks, water projects, and office buildings. This is done mainly because these facilities provide services over many years, their large dollar costs can be difficult to pay for all at once, and different generations of taxpayers benefit from the facilities. The latter fact offers a rationale for spreading the costs of infrastructure over time, as bond repayments allow you to do. In contrast, funds to operate facilities or deliver services to the public are paid out of current revenues.

What Types of Bonds Does the State Sell?

The state traditionally has sold two main types of bonds. These are:

General Fund-Supported Bonds. These are paid off from the state's General Fund, which is largely supported by tax revenues. These bonds take two forms:

- The majority are *general obligation (GO) bonds*. These must be approved by the voters and their repayment is guaranteed by the state's general taxing power. Most of these are directly paid for by the General Fund, although there are some that are paid off from designated revenue streams like mortgage or water contract payments and for which the General Fund only provides back-up security. In addition, the state recently issued GO bonds to help finance its budget deficit. Although their debt service is paid for by an earmarked one-quarter cent local sales tax, the General Fund ends up paying this amount through its increased share of Proposition 98 educational funding.
- The second type is *lease-revenue bonds*, which are authorized by the Legislature. These are paid off from lease payments (primarily financed by the General Fund) by state agencies using the facilities they finance. (Historically, most of these bonds have been used to finance higher education facilities, prisons, and state office building.) These bonds do not require voter approval and are not guaranteed. As a result, they have somewhat higher interest costs than GO bonds. Figure 1 compares key features of lease-revenue and GO bonds.

Traditional Revenue Bonds. These also finance capital infrastructure projects, but are not supported by the General Fund. Rather, they are paid off from a designated revenue stream—usually generated by the projects they finance—such as bridge tolls, parking garage fees, or water contract payments. These bonds normally do not require voter approval.

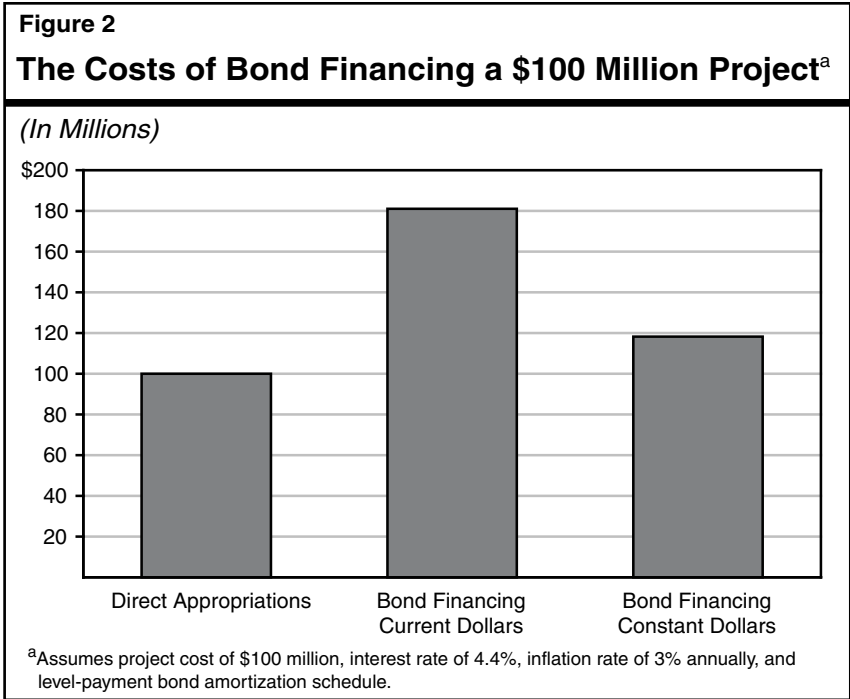
Doesn't Using Bonds Cost More?

Funding infrastructure using bonds is definitely more costly than direct appropriations due to the interest that has to be paid. This extra cost depends primarily on the interest rate and the time period over which the bonds have to be repaid. For example, the most recent GO bonds sold for an interest rate of about 4.4 percent and will be paid off over a 30-year period. Figure 2 (see page 36) shows that under these assumptions, the total cost of a bond will be about \$180 million for each \$100 million borrowed—\$100 million for repaying the amount borrowed and \$80 million for interest. However, because the repayment is spread over the entire 30-year period, the cost after adjusting for inflation is considerably less—about \$1.2 million for each \$1 million borrowed.

Figure 1

Comparisons Between State General Obligation (GO) Bonds and Lease-Revenue Bonds

Feature or Characteristic	General Obligation Bonds	Lease-Revenue Bonds
Legislative authorization needed for program	2/3 vote in each house	Majority vote in each house
Voter approval required?	Yes—majority vote of the electorate	No
Pledged security to bondholders	Full faith and credit of the state (its taxing power)	Annual debt-service appropriations, plus available bond reserve funds
Interest rate on bonds	Lowest possible	Recently has been averaging roughly 0.2 percentage point above GO bond rate
Underwriting process	Usually competitive bidding, but negotiated sales allowed if cheaper	Some competitive bidding, but most sales to date have been negotiated
Need for reserve fund to effectively market bonds?	No	Yes
Need to purchase property and liability insurance?	No	Yes
Amount of bonds required	Based on project costs, plus small amount (less than 1 percent) for issuance costs	Bond volume upsized, typically by roughly 15 percent over project costs, to cover underwriting fees, debt-service during construction period, other issuance costs, and reserve fund
Type of amortization schedule currently used	Typically level total payment (principal and interest) over 30 years	Typically level total payment (principal and interest) over 25 years
Real cost of bond financing	Lowest possible (typically about \$1.20 to \$1.30 per \$1 of capital costs)	Typically 10 percent to 15 percent above GO bond cost, depending on circumstances



So, Given This Extra Cost, Why Use Bonds?

It makes sense to pay the extra cost of using bonds when this expense is outweighed by the benefits of having projects in place sooner than otherwise would be possible. This criterion is often met in the case of capital outlays, given the large costs of infrastructure projects, the many years over which they provide services, and the substantial increases in taxes or other charges that would be needed to pay for them up front. Proposals to use more bonds, however, do raise a number of other key questions as we discuss below.

How Much Do We Already Owe?

Figure 3 shows that as of January 1, 2007, the state had \$37.7 billion of GO bond debt outstanding. (“Outstanding” debt is the total amount of bonds that have been sold less any that have been paid off.) Almost two-thirds of this debt is in K-12 education. In addition to the \$37.7 billion in GO bond debt, the state has nearly \$8 billion outstanding in lease-revenue bond debt and \$9.6 billion in deficit-financing bond debt.

Figure 3**Summary of California General Obligation Bonds
By Program Area and Type***As of January 1, 2007
(In Billions)*

	Outstanding Debt	Unissued Bonds		
		Pre-November 2006 Authorizations	November 2006 Authorizations	Total Authorizations
Corrections	\$1.0	— ^a	—	—
Health	0.1	\$0.7	—	\$0.7
Higher Education	5.0	3.2	\$3.1	6.3
Housing	—	2.1	2.9	5.0
K-12 Education	23.2	8.6	7.3	16.0
Local Government ^b	0.1	0.2	—	0.2
Resources and Flood Control	4.9	6.8	9.5	16.3
State Administration	0.2	0.2	—	0.2
Stem Cells	—	3.0	—	3.0
Transportation	3.2	0.4	19.9	20.3
Total, General Obligation Bonds	\$37.7	\$25.2	\$42.7	\$67.9

Source: California State Treasurer

^a \$10 million in unissued bonds.

^b Includes bonds for reading and literacy improvement and library construction.
Detail may not add due to rounding.

How Many Bonds Have Not Been Sold?

Figure 3 also shows that the state has not yet sold \$25.2 billion of GO bonds authorized prior to November 2006. About 70 percent of this amount, however, is already committed to specific projects, largely to education. In addition, the voters just approved \$42.7 billion in new bonds last November.

Why Are There So Many Unissued Bonds?

There are several reasons why the state typically has a large amount of authorized, but-as-yet unsold bonds:

- One reason is that when voters are periodically asked to approve bonds, the volume authorized is often expected to last for a number of years.
- A second reason is that there often is a time lag between when bonds are authorized and funds are needed for their projects. This can be because the projects involved have not yet been started, or those in progress have not yet reached construction. This, in turn, depends largely on such factors as how long it takes to acquire any necessary property, prepare any required environmental documents, develop project plans and working drawings, agree to contracts, make arrangements for actual construction to begin, and make progress on the projects themselves.
- A third factor reflects the fact that short-term loans are typically made to bond programs (using commercial paper or the state's Pooled Money Investment Account) to bridge the gap between when programs need funds and when the state sells the bonds.

Once it is time to sell bonds, they are marketed by the State Treasurer, generally through a competitive-bid auction process. This is where the bidder (often a consortium of financial firms) offering the lowest interest rate gets to purchase the bonds, generally for resale to the investment community. Typically, GO bonds from several different programs will be bundled together in a single sale.

What Does Our Debt Cost Us Each Year?

We estimate that General Fund debt payments for already authorized GO and lease-revenue bonds for infrastructure-related purposes will total about \$4.7 billion in 2007-08, rising to a peak of \$7.5 billion in 2014-15. (These numbers would increase further if bonds proposed by the Governor for future years are approved and sold. Figure 4 summarizes the Governor's proposal.) If the annual costs of the deficit-financing bonds are included, total debt-service costs will be about \$7.8 billion in 2007-08 and \$8.3 billion in 2008-09.

How Much More Debt Can We Afford?

There is no accepted "rule" for how much debt is "too much" or how many bonds the state can "afford." Rather, this depends on policy choices about how much of our revenues to devote to the funding of infrastructure versus other state spending priorities, and also what level of taxes and user charges is appropriate for the funding of infrastructure. In addition, it depends on the state's ability to sell its bonds at reasonable interest rates in the financial marketplace.

Figure 4**Governor's Proposed Bond Package—by Bond Type***(In Billions)*

	General Obligation		Lease Revenue	Revenue	Total
	2008 Ballot	2010 Ballot			
K-12 Education	\$6.5	\$5.1	—	—	\$11.6
Higher Education	7.2	4.3	\$0.1	—	11.6
Corrections	—	—	9.5	—	9.5
Flood control/ water supply	4.0	—	—	\$2.0	6.0
Courts	2.0	—	—	—	2.0
Other	0.3	—	2.3	—	2.6
Totals	\$20.0	\$9.4	\$11.9	\$2.0	\$43.3

What About the State's Low Bond Ratings—Aren't They a Problem?

California's credit ratings currently are scored as A+, A1, and A+, respectively, by the nation's three major rating agencies—Standard & Poor's, Moody's Investors Service, and Fitch Ratings. (State ratings typically range from a low of "BBB" up to the best rating of "AAA.") Although these all are investment-grade ratings and reflect recent improvement, they remain nearly the lowest of all states rated by these agencies. The state's current low ratings are principally related to factors other than the amount of debt outstanding—most notably, the continued imbalance between state revenues and expenditures and the ongoing structural deficit this implies. (Figure 5 on the next page shows the history of the state's credit ratings by the three agencies. California was last rated a AAA state in the early 1990s.) It would appear that the main adverse implication of the low ratings thus far has been the additional interest premium the state has had to pay on its new bond issues compared to what AAA-rated states pay. In recent years, this premium has been somewhat over 0.2 percentage points. Put another way, for every \$1 billion in new debt sold, the added interest cost to the state is roughly \$1.5 million annually over the life of the bonds.

Figure 5**History of California's General Obligation Bond Credit Ratings**

Standard & Poor's		Moody's Investors Service		Fitch	
Date	Rating	Date	Rating	Date	Rating
May-06	A+	May-06	A1	June-06	A+
August-04	A	July-05	A2	July-05	A
July-03	BBB	May-04	A3	September-04	A-
December-02	A	December-03	Baa1	December-03	BBB
April-01	A+	August-03	A3	December-02	A
September-00	AA	February-03	A2	February-00	AA
August-99	AA-	November-01	A1	October-97	AA-
July-96	A+	May-01	Aa3	February-96	A+
July-94	A	September-00	Aa2	July-94	A
July-92	A+	October-98	Aa3	September-92	AA
December-91	AA	July-94	A1	February-92	AA+
July-86	AAA	July-92	Aa	July-86	AAA
February-85	AA+	February-92	Aa1	October-82	AA
January-83	AA	October-89	Aaa	Prior to 1982	A
January-80	AA+	April-80	Aa		
May-68	AAA	September-72	Aaa		
		November-40	Aa		
		January-38	A		

Isn't the State's Debt-Service Ratio a Good Guideline?

Some parties in the investment community look to the debt-service ratio (that is, the DSR, or ratio of annual debt-service costs to yearly revenues) as a general guideline regarding the state's debt burden. Figure 6 shows that California's DSR increased in the early 1990s and peaked at somewhat over 5 percent in the middle of the decade. It currently stands at 4.3 percent.

Other indicators of debt capacity or affordability that sometimes have been used are the ratio of state debt outstanding to statewide personal income, and per-capita debt outstanding. California also appears to be in an acceptable range using these measures. This conclusion is similar to that for the DSR indicator noted above.

In terms of how California's debt levels compare to other parts of the country, the California State Treasurer described them as consistent with

those of other large states in his *2006 Debt Affordability Report*. The report also indicates that while the state's ratios of tax-supported debt to personal income and debt per capita rank well above the medians for the ten most populous states, several states are above California, and California's position partly reflects its deficit-related borrowing as opposed to the use of bonds for capital projects.

Does This Mean Affordability Is Not a Major Issue?

Even if the state is able to market additional debt at reasonable interest rates, it still needs to be able to make room in its budget to pay the added debt service. This is because for any given level of state revenues, each new dollar of debt service comes at the expense of a dollar that could be allocated to another program area, whether this be education, health, social services, or tax relief. Thus, the "affordability" of more bonds has to be considered not just in terms of their initial marketability, but also whether their debt service can be accommodated both on a near- and long-term cumulative basis within the state's budget, given other spending priorities. This is a particularly important consideration, given that the costs of using bonds are largely delayed, and each \$1 billion of new bonds sold at 5 percent interest adds close to \$65 million annually for as long as 30 years to state debt-service costs.

What Will the 2006 Bond Package Mean for the DSR?

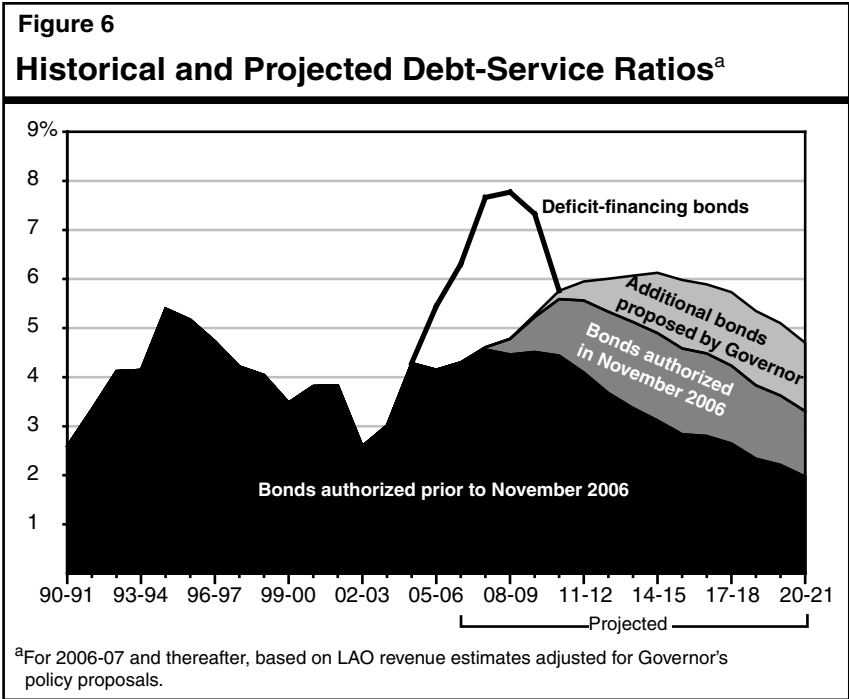
Figure 6 (see next page) also shows that the state's DSR would increase from its current level as bonds authorized in the 2006 package are sold. We estimate that the DSR would peak at 5.6 percent in 2010-11. At that time, the 2006 bond package will be adding about 1.2 percent to the DSR.

What Will the Governor's New Bond Proposals Mean?

Including the new GO and lease-revenue bonds proposed by the Governor, the DSR would peak at 6.1 percent in 2014-15. At that time, the new bond proposal would add another 1.2 percent to the DSR. To put this into perspective, this additional debt service is roughly equivalent to total state spending proposed for the In-Home Supportive Services program in 2007-08.

So What's the Bottom Line?

It certainly is possible that the state's DSR could rise to a level that might lead to some investor concerns, higher interest costs, and possibly some challenges in marketing the bonds. This might occur even if the state's bond ratings held constant or improved, due to the need to attract a



sufficient number of new bond investors to absorb the added debt. Under these conditions, it would be particularly important that the state mitigate the situation by being committed to a well-thought-out, multiyear capital infrastructure plan capable of convincing investors that the plan made financial sense, would be effectively carried out, and would eventually pay dividends in terms of benefiting California's economy. Thus, it is critical that the state have an effective capital outlay game plan and implementation process in order to accommodate a substantial amount of new bond debt without adverse financial consequences.

