REPRINT

The 1991-92 Budget:
Perspectives and Issues

State Infrastructure

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State Infrastructure

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

Summary

The state is faced with a large and growing need to revitalize and expand its infrastructure. Although it is difficult to estimate with any precision the state's infrastructure needs, it is clear that it is in the tens of billions of dollars. The defeat of various bond measures at the November 1990 statewide election has complicated efforts to address current infrastructure needs and raised concerns over the extent to which bonds can be relied on to meet needs in the future.

Based on the large volume of infrastructure needs and the state's current budgetary situation, we conclude that the state will have to rely heavily on bonds if the state's infrastructure requirements are to be addressed. This will require increasing the proportion of the budget allocated to debt service costs for capital financing. We also continue to believe that the state should rely as much as possible on general obligation bonds, rather than "lease-payment" bonds, in order to minimize General Fund debt service costs.

The above situation underscores the state's need for a statewide multi-year plan that identifies infrastructure needs and the funding requirements for addressing them. Chapter 1435, Statutes of 1990 (SB 1825, Beverly), requires the Department of Finance to prepare a plan and submit it to the Legislature by February 1, 1991. At this writing, the plan had not yet been submitted. Our analysis identifies the information which this document hopefully will provide in order to serve as a blueprint for addressing the state's capital outlay needs. We plan to report to the Legislature once the department's report comes out regarding the extent to which it accomplishes this objective.

During this last decade of the 20th century and into the next century, California will be faced with great demands to revitalize existing infrastructure and develop new infrastructure to meet the dynamic economic and demographic changes occurring in the state. By the term "infrastructure," we mean capital facilities that yield services over many years, such as roads and highways, educational facilities, prisons and jails, utility systems, and parks. During the past several years, the state's existing infrastructure has deteriorated steadily. Some progress has been made in the areas of prisons, education, and recently transportation. The progress in these areas, however, has not kept pace with demands, and little has been done in other areas to meet the state's need for additional infrastructure. This situation must be turned around if the state's infrastructure is to effectively accommodate the state's future needs. Failure in this effort could have a significant negative impact on California's future economic performance and the overall quality of life it can offer its citizens.

In this analysis, we examine some of the major infrastructure-related problems facing the Legislature. These include: (1) identifying the state's infrastructure needs; (2) setting priorities to meet these needs; (3) assessing the state's ability to finance additional bonded indebtedness needed for infrastructure; and (4) establishing a financing plan to carry out the Legislature's priorities, including the extent and timing of future bond measure submittals to the voters.

WHAT ARE THE STATE'S INFRASTRUCTURE NEEDS?

Estimates of Statewide Needs

Any estimates of costs to address the statewide infrastructure problem should be viewed cautiously. On the one hand, the data do not tend to reflect all potential needs due to the incompleteness of the state's capital planning process. This includes the need for various capital expenditures relating to earthquake hazards, some of which became more apparent following the October 1989 Loma Prieta earthquake. On the other hand, infrastructure estimates also may include proposals that, upon close examination, do not actually merit funding. Moreover, definitions of "need" vary greatly from one department to the next.

Regardless of these qualifications, available information indicates that the overall magnitude of the need for improving and expanding the state's infrastructure is very large. For example, in 1984 the Governor's Infrastructure Review Task Force reported that, over the ensuing 10-year period, approximately $29 billion would be needed for deferred maintenance and

Figure 1

Projected Capital Needs for the State and K-12 Education

1991-92 through 1995-96 (in billions)

	Five-Year Total
State/Consumer Affairs	$0.4
Transportation	12.4
Resources	0.7
Health/Welfare	0.2
Youth/Adult Corrections	5.9
Education	19.3
General Government	0.1
TOTAL	$39.0

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

$49 billion for new infrastructure. For the most part, state expenditures over the intervening seven years, with few exceptions (most notably prisons, education, and recently transportation), have only served to maintain the status quo and have done little to address the needs identified in the Task Force report. Furthermore, since that report was prepared, California's rapid economic and demographic growth has generated even more infrastructure demands.

Based on planning projections by various state departments, the current magnitude of infrastructure needs for state and K-12 school projects is $39 billion over the next five years. Figure 1 summarizes these projections.

Needs in Specific Program Areas

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

K-12 Education. Enrollment in the state's K-12 education system is projected to increase by an average of 210,000 new pupils each year over the next decade (up from projections made one year ago of 140,000 new pupils each year). The State Department of Education (SDE) estimates that school districts will require about $15 billion from state and local funding sources just in the next five years for new school buildings ($12.7 billion), school reconstruction ($1.5 billion), and air conditioning equipment in schools that adopt year-round education programs ($1.2 billion).

The SDE's estimate is based on the assumption that virtually all school districts will build schools which operate on traditional nine-month, rather than year-round, school calendars. In addition, the SDE has assumed that over the five-year period: (1) new school facilities will be needed in order to accommodate 90 percent of the annual growth in enrollment (thus, 10 percent of

the new growth will be housed in existing facilities at no additional cost); (2) 4 percent of all older school buildings will require reconstruction; and (3) air conditioning systems will be needed in one-half of the schools that adopt year-round education programs.

Transportation. The state's current program for transportation contains a total of about $9.5 billion for capital outlay projects to be readied for construction during the period 1991-92 through 1995-96. Of this amount, about $3.3 billion is to complete projects adopted in the 1988 State Transportation Improvement Program (STIP), $4 billion is for projects adopted since 1988, and $2.2 billion is reserved for projects to be identified in later years of this period.

The substantial amount of programming for new projects since the 1988 STIP reflects recent increases in gas taxes and truck weight fees enacted by Ch 105/89 (SB 300, Kopp) and Ch 106/89 (AB 471, Katz) and approved by the voters in June 1990 (Proposition 111). The new programming also reflects voter approval in June 1990 of $1 billion in general obligation bonds for rail projects pursuant to the Passenger Rail and Clean Air Bond Act (Proposition 108). Rail projects programmed during this period, however, are also dependent on voter approval of additional general obligation bond measures of $1 billion each scheduled for the 1992 and 1994 general elections. These amounts do *not* include about $2 billion of projects to be funded under the Clean Air and Transportation Improvement Act of 1990 (Proposition 116) because the schedules for funding these projects have not been determined at this time.

The transportation-related capital programming discussed above does *not* include costs associated with recovery from the Loma Prieta earthquake or of the Seismic Retrofit Program created by Ch 17x/89 (AB 36x, Sher) and Ch 18x/89 (SB 38x, Kopp). The Department of Transportation estimates that the costs of this work will total about $2.6 billion. After deducting federal emergency relief funds expected to be available and state emergency relief funds as proposed in the 1991-92 Governor's Budget, we estimate that there are about $1.5 billion in earthquake and seismic retrofit costs during the 1991-92 through 1995-96 period which, under current law, will need to be funded from resources currently programmed for other transportation capital outlay projects.

Higher Education. Enrollment in the state's three segments of higher education is expected to grow by 30 percent to 50 percent between now and the year 2005. Estimates by the higher education segments indicate that $3.9 billion will be required for capital outlay expenditures over the next five years. (This

estimate does *not* include establishment of any new campuses.) Several billion dollars more will be needed in subsequent years if the state is to accommodate the increased enrollments anticipated by 2005.

Prisons. The Department of Corrections' (CDC) latest five-year plan (April 1990) proposes construction of an additional 51,450 prison beds by 1995 at a cost of about $4.0 billion. Since publication of the five-year plan, however, the department has issued new projections which indicate faster growth in the anticipated inmate population. Based on these latest projections and using CDC's average per-bed construction cost and its current overcrowding policy, we estimate that new bed construction needs will total $5.0 billion over the five-year period, or $1 billion more than the CDC's April 1990 plan.

State Office Buildings. The Department of General Services' five-year cost estimate for state office buildings is $400 million. However, this figure is understated. This is because the plan does not sufficiently address implementation of the state's Capitol Area Plan goal of accommodating about 90 percent of Sacramento state office space needs in state-owned buildings. This goal was to be attained by 1987. The percentage of state-owned office space in Sacramento, however, has actually decreased from 64 percent in 1977 to 52 percent in 1989, as the state has elected to house more employees in leased space. The department's five-year plan also does not address the future of the Oakland State Office Building, which was damaged in the Loma Prieta earthquake and remains closed.

Seismic Safety of State Buildings and Public School Buildings. Information is incomplete regarding the need to make state buildings more earthquake-resistant. In an important first step, the Office of the State Architect has begun a seismic survey program covering all state-owned buildings, including those of the University of California and the California State University, along with all public school buildings. This effort should result in priority lists and preliminary cost estimates for those buildings that require upgrading to improve earthquake resistance. The issue of seismic safety cuts across most capital outlay program areas and will increase future capital outlay funding needs to an unknown, but significant, extent.

In June 1990, the voters approved a general obligation bond issue that included $250 million to upgrade state-owned buildings (excluding university buildings) that would be unsafe during an earthquake. These funds will only partially address the financing needs in this area.

How Firm Are These Infrastructure Needs and Costs Estimates?

The infrastructure "needs" described above are not absolute, and can change depending on policy decisions made by the Legislature. In other words, the Legislature could modify current policies in various program areas, the effect of which could be to reduce state infrastructure-related expenditure needs.

For example, in areas where the state finances local infrastructure—such as K-12 schools, community colleges, and county jails—the Legislature could return these funding responsibilities to local agencies. The state could assist local governments to meet their resulting increased financial responsibilities by seeking to eliminate the two-thirds vote requirement on local bond issues (the Governor's Budget proposes this for local jails and schools). Improved local access to this capital outlay funding source would allow the state to institute or increase local matching fund requirements or eliminate state financing altogether.

The Legislature also could adopt policies that encourage more intensive use of existing capital facilities. For example, it could more strongly encourage school districts to use year-round education to reduce the need for construction of new facilities. Increased year-round use of facilities is a strategy that also could be employed at higher education institutions to reduce needs. Other options in this area include (1) deferral of projects that do not directly accommodate enrollment, (2) expansion of existing campuses in lieu of creation of new campuses, and (3) limits on graduate and/or undergraduate enrollment.

Another example involves corrections. Options available to reduce the rate of inmate population growth—and thereby the need to build additional state prisons—include (1) placement of certain nonviolent offenders in community-based facilities (please refer to our piece on Community Corrections in this document) and (2) changes in parole supervision to reduce the number of parole violators returned to prison. Another option to reduce the need for more prisons is the adoption of higher overcrowding ratios for prisons.

Given the above, there is considerable latitude in determining exactly how much infrastructure "needs" to be funded. Even after accounting for this factor, however, there clearly is a large volume of basic infrastructure needs that will require funding.

WHAT OPTIONS EXIST FOR FINANCING INFRASTRUCTURE NEEDS?

As we have discussed in previous analyses, there are three basic ways that the state can meet its infrastructure needs. Specifically, the state can:

- Pay "up front" for facilities through direct appropriations of state revenues.
- Rent, lease, or lease-purchase facilities from private parties through annual rental or lease payments.
- Acquire facilities by borrowing money through issuing bonds that are repaid over time with interest.

The state uses each of these financing methods to some extent at present, but relies most heavily on bonds. Although bond financing is about 25 percent more costly than paying "up-front" for capital facilities (after adjusting for the effects of inflation), the large volume of infrastructure needs that presently exists in conjunction with the state's current tight budgetary situation makes it impossible to rely primarily on direct appropriations. Likewise, rental and leasing markets are simply not available for many of the types of capital facilities that the state requires. As a result, we believe the state will have to continue to rely to a great extent on bonds, if its infrastructure needs are to be addressed.

Issues Raised by the Need to Use More Bonds

As discussed above, the sheer magnitude of the state's infrastructure needs compared to available resources makes continued heavy reliance on bond financing inevitable. This situation raises two issues:

- What is the state's current bonded indebtedness situation, and what does this imply about the ability of the state to issue more bonds and the wisdom of doing so?
- What steps need to be taken to ensure that the most effective possible use of bonds occurs?

STATE BONDED INDEBTEDNESS— WHAT IS OUR CURRENT SITUATION?

Types of Bonds

The State of California uses bonds for many different purposes, ranging from financing public infrastructure like schools, prisons, and parks, to assisting private-sector small businesses and home buyers. The state's bonds generally are classified as either general obligation bonds or revenue bonds, based on the type of financial resources that are pledged to repay them. Figure 2 summarizes the state's current bond programs that fall into each of these two categories.

General Obligation Bonds. These are bonds whose principal and interest payments (that is, debt service payments) are

Figure 2

Current State Bond-Funded Programs

General Obligation Bond Programs, by Purpose		State Revenue Bond Programs, by Issuing Agency	
Beach, park, recreational facilities[a]	New state prison construction	California Alternative Energy Source Financing Authority	California Student Loan Authority
Clean water	Park and recreational facilities	California Educational Facilities Authority	California Transportation Commission
Community college construction	Parklands acquisition and development	California Health Facilities Financing Authority	California Urban Waterfront Area Restoration Financing Authority
Community parklands	Recreation, fish, and wildlife	California Housing Finance Authority	Department of Water Resources
County correctional facilities	Safe drinking water	California Industrial Development Financing Advisory Commission	Hasting College of Law
County jail construction	School building aid	California National Guard	State Public Works Board (energy conservation and cogeneration projects)
First-time homebuyers	School building lease-purchase	California Passenger Rail Bond Authority	State Public Works Board (general capital outlay projects)
Harbors	Senior centers	California School Finance Authority	University of California Regents
Hazardous substance cleanup	State construction	California State University Trustees	Veterans' Revenue Debenture (housing loans)
Health sciences facilities	State, urban, and coastal parks		
Higher education	Veterans' farm and home loans		
Lake Tahoe land acquisition	Water conservation and quality		
	Water resources development		

[a] Includes more than one bond program.

Source: California State Treasurer

guaranteed by the full faith and credit of the state's taxing authority. These bonds require voter approval and offer investors a very high degree of security. Repayment of the principal and interest on these bonds comes directly from the General Fund, or is pledged to do so if other resources backing them prove to be insufficient.

Within the classification of general obligation bonds, there are two specific types of bonds that the state issues: self-liquidating and non-self-liquidating bonds. A self-liquidating general obligation bond is one that, although backed by the full faith and credit of the state, has its debt service paid from revenues generated from the project or program that the bonds fund. (An example is veterans' housing bonds, whose debt service is paid from the monthly mortgage payments made by the veterans.) Conversely, a non-self-liquidating general obligation bond is one whose debt service is directly paid for by the state's General Fund.

Figure 2 shows that there are currently about 60 different state general obligation bond programs. These programs provide funding for a variety of purposes, including water treatment, environmental cleanup, parks, senior citizen centers, school construction, state prisons, county jails, and home purchases.

Revenue Bonds. These are bonds whose debt service payments generally are legally secured only by revenues from the projects that their proceeds finance or from some other restricted source, rather than the state's full taxing power. Examples include bonds used for pollution control facilities, student dormitories, housing mortgages, toll bridges, and water resources development. Generally speaking, revenue bonds do not require voter approval, and are not paid for by the General Fund. The one exception involves so-called General Fund lease-revenue bonds, which the state uses to fund some prison projects and higher education facilities. The debt service on these bonds *is* paid for by the General Fund, even though these are not general obligation bonds. Specifically, the debt service on the bonds is paid using annual General Fund appropriations made to the occupying state department for "lease" payments on the facility. Thus, we refer to these bonds as lease-payment bonds rather than lease-revenue bonds.

Current General Fund Debt Levels

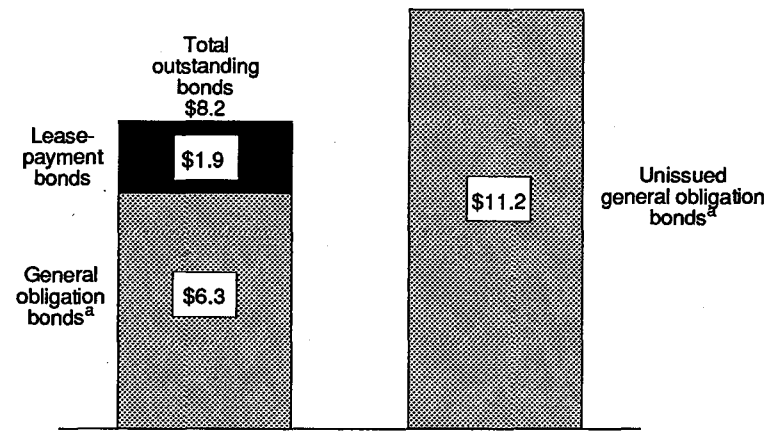
Our primary focus in the remainder of this piece will be on General Fund bonds—that is, non-self-liquidating general obligation bonds and lease-payment bonds—as these are the only bonds that impose direct costs on the state.

Figure 3 shows that, as of November 1990, outstanding General Fund bond debt totaled $8.2 billion. This included $6.3 billion in general obligation bonds and $1.9 billion in lease-payment bonds. In addition, there were $11.2 billion in authorized but unissued general obligation bonds.

Figure 3

State General Fund Bond Debt

November 1990 (In billions)



[a] Includes general obligation bonds whose debt service is fully paid by the General Fund. These bonds are generally called non-self-liquidating bonds.

Source: California State Treasurer. Data shown exclude any amounts borrowed by bond programs from the Pooled Money Investment Account (PMIA).

The Mix of Outstanding General Fund Bonds. Figure 4 summarizes how the state's outstanding General Fund bonds are distributed, by purpose and bond type. About 70 percent of the state's total outstanding bonds are for school lease-purchase programs, prisons, and higher education.

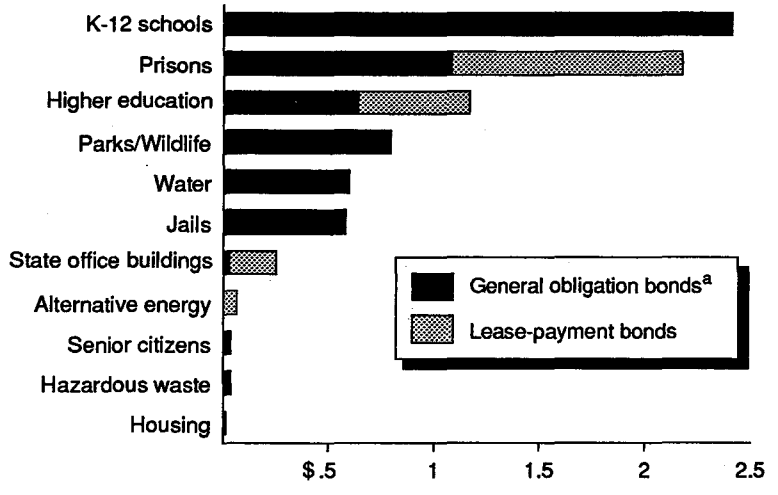
What About the Level of Unissued Bonds?

As noted above, as of November 1990, there were $11.2 billion of general obligation bonds that had been authorized by the voters of California but not yet sold. There has been considerable interest in recent years why so many bonds remain unissued. There are several reasons for this.

Figure 4

Outstanding General Fund Bonds, By Program Area and Type

November 1990 (In billions)



[a] Includes non-self-liquidating general obligation bonds.
Source: California State Treasurer.

The Role of PMIA Loans. One of the primary contributors to the current level of unissued bonds has been the federal regulations governing tax-exempt bonds. In order for the general obligation bonds sold by the state to be federally tax-exempt, the state has had to adhere to federal laws regulating bond proceeds. The Federal Tax Reform Act of 1986 generally required that the proceeds from the sale of tax-exempt bonds be spent within six months of the sale. Due to the length of time required to initiate and complete capital projects, the state chose to delay bond sales until the projects were nearing completion. Interim financing arrangements were used to pay for the projects through the state's Pooled Money Investment Account (PMIA), and then bonds were issued to pay off this interim financing.

These federal requirements were modified in 1990 to generally allow a period of two years for the expenditure of bond proceeds. As a result, the state has been taking steps to accelerate the sale of bonds and eliminate the need for interim financing.

Thus, the "built-in" delays in the sale of bonds that resulted from the federal requirements should be less of a factor in the future. At the present time, there are approximately $2.2 billion in outstanding PMIA loans to General Fund bond programs, for which bond sales have been pledged.

Program-Related Factors. Apart from PMIA loans, the level of unissued bonds is dependent upon the interrelationship between two factors: the amount of new bonds authorized by the voters in election years and the amount of bonds sold each year. Only if bonds are sold faster than they are authorized will the level of unissued bonds decline. The amount of bonds sold in any year depends primarily upon the state's readiness to use bond proceeds, including whether it has carried out the activities necessary to proceed with the sales such as the planning of the projects themselves. Generally, once bond programs are prepared to use their proceeds, commitments for bond sales are made.

In recent years, bond sales have increased steadily and are expected to total $3.1 billion in 1990-91. The budget anticipates, however, that bond sales will be $2.5 billion in 1991-92. At this rate of sales, the backlog of unissued bonds would not decline by much in the future, unless the volume of new bond authorizations from subsequent elections was significantly less than that of 1988 and 1990.

The Debt Burden

The increased volume of new bond authorizations and sales in recent years has raised some concerns about whether the state's debt level is "too high," and whether the annual cost of paying off this debt is imposing an excessive financial burden on the state budget and California's taxpayers. Clearly, *if* such conditions exist, additional bond usage could be undesirable.

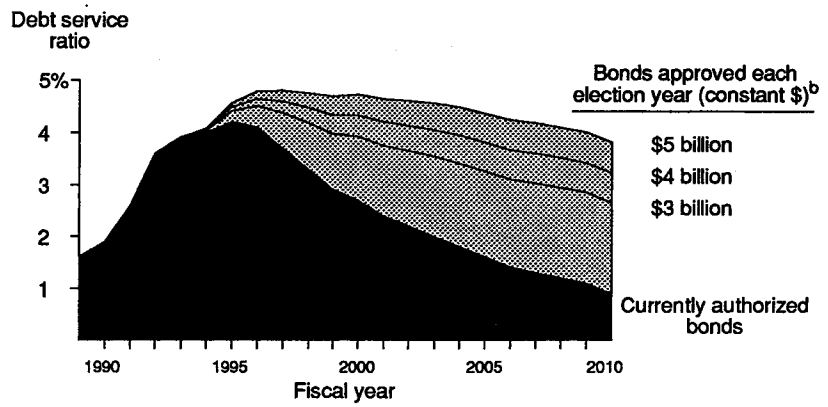
Is There Too Much Debt Right Now? There is no single correct answer to the question of how much state debt is "too much," since this depends upon one's opinions about what share of the state's financial resources should be devoted to providing public infrastructure, how capital projects should be financed, and how their costs should be spread over time. However, there are at least two reasons for concluding that California's current debt service is *not* a significant problem at present:

- ***The debt-service cost is a relatively small share of state expenditures.*** Figure 5 shows that, while debt-servicing costs on General Fund bonds have increased significantly in recent years, they still amount to well

Figure 5

Projected Trends in the General Fund Debt Service Ratio Under Alternative Assumptions[a]

1988-89 through 2009-10



[a] Data shown are for fiscal years ending in years specified. The "debt service ratio" represents General Fund costs for paying off non-self-liquidating general obligation bonds and lease-payment bonds, plus net cost of loans prior to bond sales, as a percent of total General Fund expenditures. Projections assume that new and existing-but-unissued bond authorizations are fully marketed within four years and paid off over 20 years at an average interest rate of about 7.5 percent.

[b] Constant 1992 dollars. In current dollars, the dollar amounts shown would grow by about 10 percent for each election year after 1992.

under 3 percent of estimated total General Fund expenditures in 1990-91. This is well below the national average for states of between 4 percent and 5 percent.

- ***The state's bond ratings are high.*** As of this writing, California's general obligation bonds have the highest ratings possible by all three of the nation's major bond rating agencies. Generally speaking, a state is not given bond ratings as high as California's if it is perceived as having an excessive debt burden. California was recently (January 1991) placed on "credit-watch" status by one of these bond rating agencies. However, this appears to be related to concern over the state's fiscal condition, not the level of bonded indebtedness. The state's bond ratings themselves have not yet been affected by this change.

It also is important to note that California's debt is used primarily to finance public and private long-term capital assets,

not short-lived assets or operating costs. (For a discussion of exceptions to this general rule and our related recommendations, please see our following piece on uses of bond proceeds.) Virtually all of the state's debt-servicing payments essentially represent the public's ongoing costs for using capital assets *currently generating benefits* to them. Economists agree that this type of debt can be economically justified, and is fundamentally different from the federal government's debt, most of which has been incurred simply to finance ongoing operational expenses.

Given the above, there is no evidence that California's current debt burden is excessive or poses any significant fiscal threat at this time. Clearly, this does not mean that the state can afford to issue bonds in limitless amounts or use them indiscriminately in the future. However, it does mean that *there is sufficient "room" for the state to continue issuing bonds in the future for financing its basic long-term capital needs.*

What About the Future Debt Burden? As indicated above, the state has yet to sell about $11 billion in authorized general obligation bonds. As these bonds are marketed in the coming years, the state's debt service ratio (the ratio of General Fund debt service to General Fund expenditures) will increase from the current estimated level of 2.6 percent for 1990-91. As Figure 5 shows, the projected debt service ratio will increase to about 4.2 percent in 1994-95, and then decline thereafter, assuming no additional bonds are authorized in future years and given reasonable assumptions regarding the pace at which bonds are sold.

Figure 5 also shows what the state's debt service ratio would be, assuming that various additional amounts of general obligation bonds are approved by the voters and sold in the future. For example, if the voters were to approve an additional $5 billion of general obligation bonds in each future election year (with increases for inflation), the state's debt service ratio would peak at about 4.8 percent in 1996-97 and then begin to decline slowly. Thus, even in this case, the debt service ratio would remain manageable and not exceed the national average.

Should There Be a Limit on the State's Debt Level? As the state has increased its use of bond financing in recent years, the idea that the state should adopt a formal debt limit has received increasing attention. It is our view that California does *not* need a debt limit. This is because such a limit could, in some cases, *prevent* the Legislature and the Governor from exercising their responsibility to make capital outlay decisions in a fashion consistent with the needs of the state. While it is true that there may be some tendency for additional bond issuances to be sought simply to avoid direct spending, the use of a capital outlay plan-

ning process should act as an effective "screening device" to help minimize inappropriate uses of the state's bond authority. Thus, *the key thing for the Legislature to focus on is not how many bonds to issue per se, but rather the trade-off between using state revenues to pay debt service on bonds needed to fund infrastructure, versus using these revenues to support or enhance other state programs.*

Implications of the November 1990 Election

In November 1990 California's voters were asked to approve 14 bond measures authorizing some $5 billion in new bonded indebtedness. Historically, with few exceptions, the voters have approved similar bond measures. This time, however, all but two measures failed—an $800 million measure for K-12 school construction and a $400 million measure for the veterans' farm and home purchase (Cal-Vet) program. The failure of the other 12 bond measures to pass raises concerns over (1) the extent to which general obligation bonds can necessarily be counted on to meet infrastructure needs in the future and (2) how to meet immediate infrastructure needs, given that most of the bond money sought in November 1990 will not be available.

To address the first concern—the availability of bonds in the future—we believe the most important step to be taken is to improve the state's capital outlay planning process (see discussion below). As to the immediate funding problem, the defeat of various bond measures in the November election has created significant funding "gaps" for the 1991-92 fiscal year in areas such as state and local correctional facilities, higher education, and parks. The following is a brief discussion of implications of the funding "gaps" for higher education and state prisons.

Higher Education. California's voters denied a $450 million measure for higher education facilities in November 1990. The capital outlay spending plans of the higher education segments (University of California, California State University, and community colleges) called for $690 million in 1991-92, based partly on the assumption of passage of this bond measure. Although it may be that, upon examination, not all proposals in the segments' plans would necessarily merit funding, failure of the bond measure definitely limits the state's ability to address the priority needs of these plans. For example, the *1991-92 Governor's Budget* provides only about 55 percent of the funding requested by each segment (the majority of proposed funding is with General Fund lease-payment bonds versus general obligation bonds). Moreover, the capital outlay projects either (1) proposed in the budget or (2) previously approved by the Legisla-

ture will require an estimated $650 million to complete. In addition, the spending plans do not include any proposals for new campuses that may be required to accommodate future enrollment growth.

For a more detailed discussion of higher education facility needs, including the funding gaps for financing them, please see our overview of higher education capital outlay in the *Analysis of the 1991-92 Budget Bill.*

Prisons. The defeat of the $450 million bond measure for new prison construction leaves the Department of Corrections (CDC) without adequate funds to complete its proposed program. The CDC's current five-year plan calls for construction of an additional 51,450 prison beds by 1995, at a cost of $4.0 billion. To fund the 1990 portion of the program, the Legislature enacted Ch 981/90 (SB 549, Presley), appropriating $692 million for construction of 14,650 beds. Of this amount, the Legislature appropriated about $280 million from the bond fund that subsequently was denied approval by the voters in November. Thus, the failure of the bond measure leaves the CDC without enough general obligation bonds either to (1) complete all the projects already approved by the Legislature or (2) construct additional prisons in the future.

Lacking significant policy changes, inmate population will continue to grow rapidly and the state, for all practical purposes, will need to spend up to $4 billion by 1994-95 to construct new prisons. Furthermore, the need for new prisons would not end at that point, as similar amounts probably will be needed during the following five-year period. Thus, a significant funding gap will exist unless the Legislature adopts other policy options to reduce this growth and thereby reduce the need for additional prisons.

WHAT STEPS NEED TO BE TAKEN?

In order to address its pressing infrastructure needs and related bond financing needs, we have previously said that the state needs a statewide capital outlay plan to (1) identify and prioritize infrastructure needs and (2) serve as the foundation for a financing plan to establish the extent and orderly timing of bond authorizations. The Legislature enacted a capital outlay financing plan requirement in 1990 which, hopefully, will accomplish this objective. This section discusses the types of information the Legislature needs to make informed decisions in this area, what the new legislation provides for, and several other issues involving how best to address and finance the state's infrastructure needs.

To date, the state's process for identifying, ranking, and financing its capital outlay needs has been fragmented. The Legislature has received a series of independent five-year plans in most program areas, but there has been no centralized compilation nor ranking of projects across programs to provide a statewide perspective. Moreover, each department has developed its plan in the absence of uniform guidelines regarding the identification of programmatic objectives and the evaluation of programmatic needs. Not only has each plan been developed in isolation from the others, but, once developed, no effective process has existed to bring the plans together to reflect statewide priorities.

As a result of these problems in the planning process, there has been no easy way to identify either (1) the relative priority of various programs and proposals or (2) the financing required to address overall state needs.

What Information is Needed?

In order to meet the state's infrastructure needs, the Legislature should have a capital outlay plan containing specific information concerning needs, relative priorities, and schedules for implementation and financing individual projects. To be most useful to the Legislature, this information should include for each major program area (such as the University of California, Department of Corrections, etc.) summary presentations identifying:

- Major programmatic objectives.
- How facility needs were assessed and determined within the framework of these programmatic objectives.
- The criteria upon which identified needs were prioritized.
- Anticipated annual operations cost requirements associated with the capital outlay programs.

For each program area, the required major capital outlay projects should be identified by year, by amount of expected expenditure, and by anticipated manner of funding (general obligation bond, General Fund lease-payment bond, etc.). Finally, to provide a *statewide* perspective, the various plans should be combined with criteria for setting priorities between projects and across program areas, and a plan for financing the identified needs.

New Planning Document Will Hopefully Provide Blueprint for Meeting Needs

Chapter 1435, Statutes of 1990 (SB 1825, Beverly), requires the Director of Finance to prepare a 10-year projection of the state's potential need for financing capital outlay. This report is due to the Legislature by February 1, 1991 and is to be updated annually. At the time this analysis was written, the report had not yet been submitted. Hopefully, this document will include the information necessary to serve as a blueprint for a financing plan. As noted earlier, such a plan is needed to enable the Legislature and the administration to establish appropriate allocation of fiscal resources to meet state infrastructure needs, including when and how many bonds to present to the voters at statewide elections.

As mentioned earlier in this analysis, because of the magnitude of infrastructure funding needs, we believe bond financing must play the key role in any financing scheme. This means that the Legislature will need to request the voters to approve large amounts of additional general obligation bonds in the future.

What If the Needed General Obligation Bond Issues Are Not Authorized? The implications of not obtaining additional general obligation bond authorizations are that (1) fewer capital needs can be addressed and/or (2) more costly debt financing means will have to be used—such as General Fund lease-payment bonds.

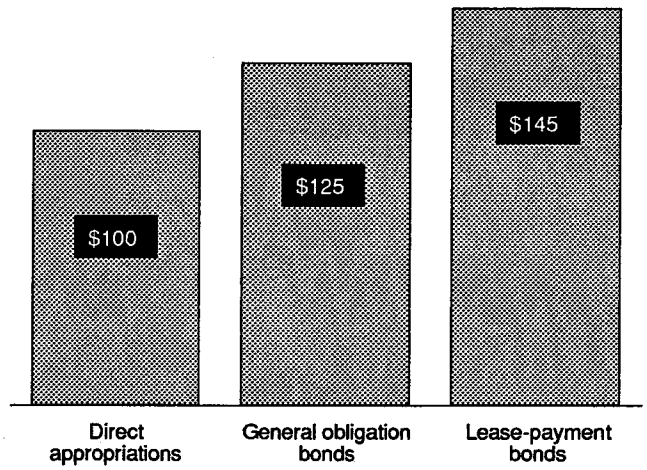
Under the first case—*addressing fewer capital needs*—the state will be faced with limiting the objectives of many programs because of the lack of sufficient facilities, even though the Legislature may consider the program objectives a high statewide priority. Failure to adequately fund infrastructure will negatively affect public services in such areas as education, corrections, transportation, environmental quality, and seismic safety. For example, it could result in such problems as an inability to accommodate all qualified students for higher education, court-ordered release of some prisoners, and inadequate sewer and water systems.

The second alternative is that the Legislature could use *more costly financing means* to fund infrastructure and avoid these negative outcomes. As discussed previously, General Fund lease-payment bonds can be used to finance infrastructure improvements. This funding mechanism does not require voter approval. These bonds, however, are more expensive and therefore increase the state's debt service costs at a faster rate than if general obligation bonds are used. Figure 6 shows that the difference in

Figure 6

Relative Costs of Bond Financing For a $100 Million Project [a]

(in millions)



[a] Assumes a 20-year bond issue with an average interest rate of 7.5 percent for general obligation bonds and 8 percent for lease-payment bonds. Amounts shown are in constant dollars using an average annual inflation rate of 5 percent.

financing costs using general obligation bonds versus General Fund lease-payment bonds is about 15 percent after adjusting for the effects of inflation. That is, for every $100 million of capital improvements the state would need to pay about $125 million if general obligation bonds are used and $145 million if lease-payment bonds are used. (The costs to pay for the capital improvement are higher under both methods of bond financing than under direct appropriations, because of the interest expenses and other unique costs associated with debt financing.)

Given the fiscal advantages of general obligation bonds over lease-payment bonds, ***we recommend that the Legislature rely to the maximum extent possible on the former when addressing its infrastructure needs through debt financing.*** A capital outlay plan—such as the one required under Ch 1435/90 (SB 1825, Beverly)—should help the Legislature achieve this end through improved planning, identification of the state's highest priority needs, and scheduling of necessary general obligation bond measures for future ballots.

What Are Some of the Factors That Influence the Amount of Bonds That Will Be Available in the Future? The amount of bonds that will be available in the future for funding infrastructure will depend on such factors as:

- The Legislature's and the administration's overall spending priorities based on assessment of the needs identified in a statewide capital outlay plan.
- The amount and timing of those infrastructure needs identified in the statewide capital outlay plan.
- The Legislature's views on what the acceptable levels of bonded indebtedness and debt service costs are, based on factors such as other spending priorities and credit rating concerns.
- The voters' willingness to approve new general obligation bond authorizations. In this regard, we believe a well developed capital outlay plan that includes an assessment of statewide infrastructure needs and a financial plan to accomplish its elements will help voters look more favorably on future general obligation bond measures.
- The Legislature's willingness to permit more expensive non-voter-approved lease-payment bonds to be used as an alternative to general obligation bonds.

The Plans Must be Flexible and Regularly Reevaluated. No plan, however well conceived and developed, can anticipate all needs or all future changes in circumstances. This certainly applies to any capital outlay needs and financing plans developed by the state. The Legislature, therefore, should keep this in mind when drafting future bond measures. These measures should give the voters a clear sense of the programs to be funded—*in broad terms*. They should not, however, schedule the permitted appropriation of funds on a specific project-by-project or geographic basis. This scheduling should be done through appropriations in the annual Budget Act. Otherwise, the Legislature will find that it does not have discretion in matching appropriations with changing needs, priorities, and circumstances.

CONCLUSION

The state must improve and expand its infrastructure to address existing deficiencies and to prepare to accommodate future demographic and economic growth. Based on recent reports and information from various state departments, it is clear that the state's infrastructure needs over the next several

years are easily in the tens of billions of dollars. In view of the magnitude of these costs, the state must identify specific needs, set priorities, and establish a financing plan to carry out the necessary improvements. The state will have to rely heavily on borrowing money through the issuance of bonds, and should try to rely to the maximum extent possible on general obligation bonds rather than "lease-payment" bonds.

In order to address its infrastructure needs effectively, the state needs a multi-year capital outlay plan and a related capital financing plan. Hopefully, the plan presently under preparation by the Department of Finance in response to Ch 1435/90 (SB 1825, Beverly) will include the necessary information to serve as a blueprint for developing a financing plan that will assist in scheduling future bond measure submittals to the voters and help promote their successful passage at statewide elections. We will be reporting to the Legislature once this plan is released regarding its contents and findings.

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