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Bonds and the 1994 Ballots

SUMMARY

The Legislature faces important decisions on the bond package to be placed on the 1994 ballots. The following must be considered when the Legislature decides which general obligation bonds to place before the voters:

- **California** has capital infrastructure needs totaling tens of billions of dollars over the next decade. This includes the needs of state agencies and local entities (such as school districts) that have received funding from previous state bond issues.
- **The state's debt burden** has risen sharply in recent years—to an estimated 5 percent of General Fund revenues for 1993-94. This ratio will rise to 5.5 percent when all bonds previously authorized by the voters and the Legislature are sold.
- **Only about $1.8 billion** in authorized general obligation bonds remain uncommitted to specific projects. Two-thirds of this amount is for transportation (rail) programs.
- **Three bond measures** totaling $3.2 billion have already been placed on the 1994 ballots. The largest of these is a $2 billion resources measure placed on the ballot by initiative.

We urge the Legislature not to use an arbitrary debt-service ratio as the sole or driving factor in making decisions on bonds. *The key consideration should be the tradeoff of using state revenues to pay debt service on bonds to develop infrastructure versus using these revenues to support or enhance other state programs.* It is critical that the Legislature establish infrastructure priorities and target future state bonds to address these priorities.

There are currently 29 bond measures—totaling $16.6 billion—before the Legislature. We describe some key factors for the Legislature to consider in deciding which bonds to place on the 1994 ballots.

"How well the state addresses its infra-structure needs will influence the state's future competitiveness and economic growth, and Californians' quality of life."

INTRODUCTION

During the upcoming months, the Legislature must decide which general obligation bond measures to place on the June and November 1994 ballots for voter approval. These decisions are important because general obligation bonds have been one of the primary ways that the state has financed its own capital infrastructure, as well as that of some local government entities

The following factors must be considered as the Legislature decides which state general obligation bonds to place before the voters:

- ❖ California has infrastructure needs totaling tens of billions of dollars.
- ❖ The state's debt burden has risen sharply in recent years.
- ❖ Previously authorized state general obligation bonds are largely depleted.
- ❖ $3.2 billion in bond measures are already on the 1994 ballots.

Without additional general obligation bond authorizations, either fewer infrastructure needs will be addressed or more costly debt financing—such as lease-payment bonds—will have to be used. How well the state addresses its infrastructure needs will influence the state's future competitiveness and economic growth, and Californians' quality of life.

What Are The State's Capital Infrastructure Needs?

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

Administration's Plan Not Based on Specific Needs or Priorities

In February 1993, the DOF released its annual report on the state's 10-year capital outlay and infrastructure needs, pursuant to Ch 1435/90 (SB 1825, Beverly). As shown in Figure 1, the DOF estimated *$50 billion* in state-funded infrastructure (at state and local levels) over the *10-year period* of 1993-94 to 2002-03. (The DOF's plan issued just one year earlier identified a ten-year funding level of $60 billion.)

It is important to note, however, that the DOF estimate of "needs" is not based on an evaluation of identified problems or projects. Rather it is based on an allocation of funding projected to be available over the next 10 years for capital infrastructure. For the most part, the DOF defines the available funding level by capping the state's future debt service ratio (bond debt service costs as a percentage of General Fund revenues) at 5 percent. (The 5 percent level is commonly used by bond rating agencies

Figure 1

Department of Finance Capital Outlay Plan 1993-94 through 2002-03

(In Billions)

	Ten-Year Total
State Office Buildings	$1.2
Transportation	30.2[a]
Natural Resources and Environmental Quality	4.0
Public Safety	5.8
Higher Education	7.4
Other[b]	1.5
Total	**$50.1**

[a] Includes $26.2 billion to be funded from state and federal gasoline tax revenues, state truck weight fees, and tolls on state-owned toll bridges for the Department of Transportation.

[b] Includes state-operated hospitals and laboratories and low income housing.

Source: Department of Finance, 1993 Capital Outlay and Infrastructure Report (February 1993).

as an indication of a relatively high debt burden.) The $50 billion would be financed from General Fund-supported bonds ($21.6 billion), special funds ($16.6 billion), and federal funds ($11.9 billion).

In addition, some of the assumptions used in establishing the 10-year financing scheme are no longer valid. For example, the 10-year total excluded any additional state bonds for K-12 school projects. This reflected the administration's support of Proposition 170 (ACA 6), which would have allowed a majority vote for approval of local school bonds. With the failure of Proposition 170 in the November 1993 election, however, some level of continued state funding for schools, while not required, is likely. Furthermore, the DOF assumed the authorization of $900 million in new lease-payment bonds for state office buildings over the entire 10-year period. This assumption appears too low. In 1993 alone, the Legislature authorized several new office building projects (estimated cost of over $700 million), and the Department of General Services is planning to acquire several million more square feet of state office space in the next decade (cost will probably exceed $2 billion).

In general, we find that the current DOF plan as well as prior plans developed by the DOF provide little useful information to guide the Legislature in making decisions on infrastructure needs and bond allocations.

" . . . it seems clear that the state will have to invest tens of billions of dollars in infrastructure over the next decade."

State Agencies' Five-Year Capital Outlay Plans Offer Specifics

The five-year capital outlay plans submitted annually by state agencies provide a project-specific inventory of needs. Figure 2 provides a summary of these *five-year plans,* which total *$41 billion* for state agencies and for K-12 education from 1994-95 to 1998-99. This amount includes $13 billion from special and federal funds for transportation capital outlay and $28 billion in other state agency and K-12 needs.

Figure 2

Projected Capital Outlay Needs For the State and K-12 Education 1994-95 through 1998-99

(In Billions)

	Five-Year Total
State/Consumer Services	$1.5
Transportation	14.9[a]
Resources	0.6[b]
Health/Welfare	0.3
Youth/Adult Corrections	1.8
K-12 Education	15.0[c]
Postsecondary Education	6.3
General Government	0.3
Total	**$40.7**

[a] Includes $13 billion in funding from state and federal gasoline tax revenues, state truck weight fees, and state toll bridge revenues for the Department of Transportation.

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

[c] No statewide five-year plan. General estimate only.

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

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

The estimates included in the above plans should be viewed with caution, because the plans are incomplete and also may include proposals that, upon examination, do not merit funding. While recognizing the shortcomings of these plans, we believe they provide a reasonable assessment of the overall magnitude of need in those areas included in the plans. Thus, using these documents as benchmarks, it seems clear that the state will have to invest tens of billions of dollars in infrastructure over the next decade. Moreover, the costs will be significantly higher if the state continues to issue state bonds for non-state facilities (such as local jails, parks, libraries, and water quality/treatment plants).

Most Authorized Bonds Are Already Committed

Figure 3 summarizes the state general obligation bond acts which still have funds uncommitted to specific projects. About $5.4 billion of the nearly $17 billion of these authorized general obligation bonds have not been sold. This $5.4 billion, however, is not all available for future appropriations. This is because of the time lag between constructing approved projects and the sale of bonds for those projects. When commitments for existing projects are accounted for, only about $1.8 billion remains available for allocation or appropriation. (This compares to about $3.5 billion that was available just one year ago.)

Almost two-thirds of these uncommitted bond funds are for transportation (rail programs). Of the $1.1 billion in uncommitted rail bonds, $1 billion authorized in Proposition 116 is designated for specific transit corridors. Aside from transportation, *only about $600 million remains uncommitted in all the other bond-funded programs*. Clearly, there are insufficient authorized bonds remaining to finance the multi-billion dollar infrastructure programs identified by those state and local entities that have increasingly relied on state bonds to finance these programs.

Figure 3

Status of Existing General Obligation Bonds

(In Millions)

Program	Authorized[a]	Unsold Total[b]	Unsold Uncommitted
Transportation	$2,990	$1,812	$1,150
Parks/resources	1,881	276	10
Safe drinking water/clean water/ water conservation	1,400	266	2
County correctional facilities	995	179	3
State prisons/youth authority	1,767	244	101
K-12	5,200	1,544	178
Higher education	1,950	780	94
Libraries	75	39	—
Public buildings—seismic upgrading	300	272	237
Totals	**$16,558**	**$5,412**	**$1,775**

[a] Amount authorized by the voters.
[b] Does not include $185 million from First Time Home Buyers Bond Act of 1982. No bonds have been issued since 1983.

HOW ARE THE STATE'S CAPITAL INFRASTRUCTURE NEEDS FINANCED?

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

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

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

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

" . . . there is a trade-off between using bonds to fund the state's infrastructure needs and funding the state's ongoing General Fund programs. It is, therefore, critical to weigh the costs and benefits of these long-term investments against the costs and benefits of providing other state services."

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

Lease-Payment Bonds. Lease-payment bonds (commonly referred to as lease-revenue bonds or Public Works Board bonds) do not require voter approval. The debt service on most of these bonds is paid from the General Fund (usually through annual lease payments made by the state agency using the facility), but is not backed by the full faith and credit of the state. Lease-payment bonds are rated lower than general obligation bonds and therefore are sold at a higher interest rate. In addition, these bonds typically require a reserve fund for the construction period, another reserve fund over the life of the bonds, additional administrative costs, and in some cases insurance costs. As a result of all of these factors, lease-payment bonds cost more than general obligation bonds, and therefore, use up more of the state's debt capacity without providing any additional program benefits.

What Are the Trade-offs Associated With Using Bonds?

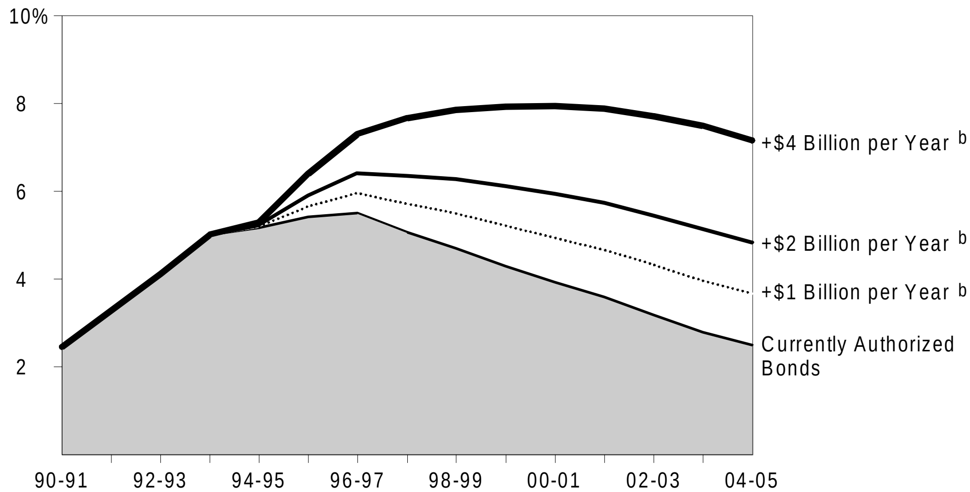
As discussed above, financing with direct appropriations is less costly than financing with bonds. For example, a project that would cost $100 million with a direct appropriation would cost the state about $118 million if financed with general obligation bonds, and $129 million if financed with lease-payment bonds, after adjusting for inflation.

If it's cheaper to finance capital outlay needs through direct appropriations, why should the state use bonds? Just as most families cannot pay "up front" the cost of a house, the state cannot afford to finance many of its assets in such a way. Thus, the use of bond financing allows the state to acquire assets sooner than it otherwise could. In addition, since capital infrastructure generates benefits to citizens over many years, it often makes sense to spread these costs over time among the different beneficiaries.

It is also important to note that, whenever the state chooses to fund its needs by using bonds, the state is making an additional long-term commitment of General Fund monies. For instance, for every $1 billion in general obligation bonds sold, the state is committing to pay about $71 million in annual debt service costs for the next 25 years. Consequently, there is a trade-off between using bonds to fund the state's infrastructure needs and funding the state's ongoing General Fund programs. It is, therefore, critical to weigh the costs and benefits of these long-term investments against the costs and benefits of providing other state services.

Figure 4

Projected Debt-Service Ratio[a]
1991-92 Through 2004-05



[a] Assumes interest rates on general obligation bonds: 5.5 percent in 1994, 6 percent in 1995 and 1996, and 6.5 percent thereafter. Assumed interest rates on lease-payment bonds are 0.3 percent higher than interest rates on general obligation bonds.
[b] Assumes additional sales of general obligation bonds for ten years starting in 1994-95.

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

For 1993-94, the state's debt ratio is about 5 percent, which is relatively high compared to other states. This ratio has risen sharply in recent years, as it was 2.5 percent in 1990-91. In the current year, the state will pay an estimated $2 billion in debt service. While the state has sold relatively more bonds in recent years, a significant reason for the increased debt burden has been the decline in General Fund revenues.

Figure 4 shows what would happen to the debt ratio in the future under several scenarios. If all currently authorized general obligation bonds and lease-purchase bonds are sold (but no others are authorized), the debt ratio would reach a peak of about 5.5 percent in 1996-97 and decline to 2.5 percent in 2004-05.

The figure also shows how the state's debt ratio would increase if various levels of additional general obligation bonds (no additional lease-payment bonds) are sold each year for the next 10 years. For example, if an additional $2 billion was sold annually ($4 billion authorized in each two-year election cycle), the debt ratio would peak at 6.4 percent in 1996-97.

"Given the state's relatively high debt burden and the multi-billion dollar infrastructure needs, it is critical that the Legislature establish its infrastructure priorities and assure that future state bonds are targeted to address these priorities."

At this bond funding level, only about two-thirds of the unfunded *five-year* capital outlay needs of state agencies and K-12 education could be addressed over the next 10 years.

For $1 billion and $4 billion of additional annual sales, the debt ratio peaks at 6 percent and 7.9 percent, respectively. These ratios will be higher if lease-payment bonds are used in lieu of or in addition to general obligation bonds. Actual future debt ratios will, of course, depend on the timing, volume, and interest rates on bond sales, and on actual General Fund revenues.

What Level of Debt Should the State Assume?

We do not believe there is a "right" ratio of debt-service costs to General Fund revenue. Under some circumstances a ratio under 5 percent may be too high given the state's overall fiscal condition. In other cases a ratio above 5 percent may be too low given the condition of the state's infrastructure and its overall economy. We urge the Legislature not to use an arbitrary debt-service ratio as the sole or driving factor in determining the level of bond financing. Of course, the Legislature must make prudent decisions in this area of long-term planning and financing of capital investments. *The key thing for the Legislature to focus on, however, should be the tradeoff between using state revenues to pay debt service on bonds to develop the state's infrastructure versus using these revenues to support or enhance other state programs.* Given the state's relatively high debt burden and the multi-billion dollar infrastructure needs, it is critical that the Legislature establish its infrastructure priorities and assure that future state bonds are targeted to address these priorities.

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

We believe that there are several key factors for the Legislature to consider in making decisions about which bonds to place on the 1994 ballots. These factors are summarized in Figure 5 and discussed below.

Figure 5

Key Considerations in Allocating Bond Authorizations

- ✔ Is the infrastructure program clearly a state responsibility?
- ✔ If the program is a local responsibility, when should the state assist with funding?
- ✔ Are there ways to reduce the infrastructure needs?
- ✔ Is the infrastructure program urgently required for health and/or safety purposes?
- ✔ Will funding be available to operate and maintain the capital investments?

Is the Infrastructure Program Clearly a State Responsibility?

Maintaining and improving the assets of programs for which the *state* is responsible should be the first and foremost priority. The degree to which these needs have been addressed has varied greatly among state departments—largely depending on the fund sources available to each agency. For example, the higher education segments and the state prison system have received billions of dollars in bond funding for their capital programs. Likewise, many special-funded agencies—such as the Department of Motor Vehicles, the California Highway Patrol, and the Employment Development Department—have been able to devote a reasonable level of funding to their programs through "pay-as-you-go" appropriations. General Fund departments, such as Forestry, Mental Health, and Developmental Services, have been much less successful in sustaining ongoing programs to address their capital needs. These departments, which administer substantial, older assets, have developed a considerable backlog of infrastructure needs. The Legislature should develop a long-term strategy to also address these departments' capital programs, either by authorizing bond funding or devoting a portion of ongoing funds.

If the Program Is a Local Responsibility, When Should the State Assist with Funding?

In making this determination, the Legislature needs to know what the ability is of the local entity to fund their own programs and what steps the state could take to make it easier for the local entity to assume more responsibility, or even total responsibility, for the program. The Legislature attempted to address this issue for K-12 schools and the community colleges with Proposition 170 (ACA 6). With the failure of that measure, the Legislature may have to look at restructuring these and other state-funded local assistance programs in order to stretch any future state bond funds further. Such restructuring could, for example, include requiring greater local cost sharing or targeting state assistance to low-wealth local entities.

Are There Ways to Reduce the Infrastructure Needs?

Policy changes could reduce the need for spending on infrastructure. Examples of these changes would be steps to reduce the current and future "caseload" to be served in various programs. In the education area, these could include more year-round use of K-12 schools and college / university campuses and more shared use of facilities, such as libraries. In the criminal justice area, it could include a wide variety of policy choices to reduce inmate population. In contemplating any such policy choices, the Legislature would have to weigh the implications of the programmatic changes with the benefits of reducing future infrastructure needs.

Is the Infrastructure Program Urgently Required for Health and/or Safety Purposes?

Another factor to consider is whether the program would address those health and/or safety hazards that are considered the most critical by the Legislature. For example, are there life-threatening situations within the state's 24-hour institutions? Are there identified areas of immediate personal danger involving state facilities or structures (such as bridges) in the event of an earthquake?

Will Funding be Available to Operate and Maintain the Capital Investments?

Capital projects to rehabilitate older facilities tend to reduce operating and maintenance costs. On the other hand, funding new capital projects requires additional ongoing operating costs that must be funded through the state's General Fund or special funds, or—in the case of a local government project—through local funds. For example, San Diego County recently constructed a 1,000-bed jail and was unable to open it because of the lack of funds for operating expenses. Moreover, the state has postponed the opening of several prisons because of operating budget constraints. Consequently, it is essential that the Legislature have information on the capacity of the state's or the local government's budget to operate facilities once constructed or rehabilitated.

"As of January 3, 1994, there were 29 separate bond measures before the Legislature."

WHAT BOND MEASURES ARE BEFORE THE LEGISLATURE?

As of January 3, 1994, there were 29 separate bond measures before the Legislature. Figure 6 summarizes these 29 measures, which total $16.6 billion. (The total without double-counting those measures that fund nearly identical programs is $8.3 billion.) Programmatically, the $16.6 billion is comprised of $6.2 billion in resources, $6.1 billion in education, $1.0 billion in corrections, and $3.3 billion in "all other."

The amount of bonds proposed for certain programs, such as corrections or higher education, would fund only a small fraction of the identified needs. In addition, no bonds are proposed for some *state* capital programs, such as constructing state office space, rehabilitating the state developmental centers and hospitals, or upgrading fire fighting/protection facilities. About $7.4 billion of the bonds are for projects that would be developed by *entities other than the state*, such as cities, school districts, and water authorities.

Figure 6

General Obligation Bonds Proposed for the 1994 Ballots[a]

Bill	Author	Authorization (In Millions)	General Program Area
Resources: Water			
AB 184	Collins	500	Auburn Dam
AB 185	Knowles/Andal	1,200	Auburn Dam
AB 370	Cortese	360	Water recycling, clean water
AB 638	Peace	150	International border toxics clean-up
AB 1474	Costa	50	Clean water
AB 1514	Jones/Costa	Unspecified	Inland fishery habitat; water export facilities
AB 1637	O'Connell/Cortese	495	Clean water; safe drinking water; flood control
SB 61	Ayala	1,200	Auburn Dam
Resources: Other			
AB 821	Cortese	200	Parks, natural resources
AB 1128	Cortese	877	Parks, natural resources
SB 158	Thompson	885	Parks, natural resources
SB 473	Mello	263	Coastal and riparian habitat
Education			
AB 163	Areias	700	Higher education
AB 527	Murray	900	K-12 education
AB 1261	Eastin	200	Educational technology
AB 1700	Eastin/Murray	1,400	K-12 education
SB 46	Hart	900	Higher education
SB 190	Greene	1,000	K-12 education (June)
		1,000	K-12 education (November)
Corrections			
AB 165	Murray	450	Adult and juvenile facilities
SB 1071	Presley	500	Adult and juvenile facilities
Other			
AB 61	Alpert	100	Libraries
AB 210	Hauser	300	Housing
SB 131	Roberti	280	Housing
SB 174	Marks	150	Libraries
SB 379	Lockyer	50	Courthouse security
SB 596	McCorquodale	1,000	Local government capital projects
SB 710	Watson	Unspecified	Child care
SB 844	Presley	1,000	Infrastructure, housing, natural resources
SB 1182	Alquist	475	Earthquake safety: state and local government buildings
Total, all proposals		**$16,585**	
Total, without double-counting		**$8,305**[b]	

[a] Status of proposals as of January 3, 1994.
[b] Excludes authorizations for which another measure exists that calls for a nearly identical program.In these cases the highest proposed authorization was used.
Source: Legislative Analyst's Office.

Bond Issues Already on the 1994 Ballots

Three measures, totaling $3.2 billion, have already been placed on the 1994 ballots. They are: (1) a $2 billion initiative for state and local parks and natural resource protection programs (June ballot); (2) $1 billion for rail projects (November ballot); and (3) $185 million for a first-time home buyers program (November ballot).

CONCLUSION

The state will have to rely, to a great extent, on bond financing to meet its infrastructure needs, which total tens of billions of dollars over the next decade. In deciding the 1994 bond package, an important consideration is that the use of bond financing requires a long-term commitment of General Fund monies and, thus, entails a trade-off between expenditures for long-term capital investments and ongoing General Fund-supported programs. It is, therefore, essential that bond authorizations be directed to the state's highest priority infrastructure needs. This paper identifies several factors which can help the Legislature in making these decisions.

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