CALIFORNIA BUDGET PROJECT

BUDGET BACKGROUNDER

February 2006

MAKING DOLLARS MAKE SENSE

A MINI-PRIMER ON BONDS

Governor Schwarzenegger's $222.6 billion public works proposal, along with alternative proposals by various legislators, is the "hot topic" of the current legislative session. Many of the pending proposals would rely on bonds – money the state borrows and pays back over a number of years – to finance public investments. This *Budget Backgrounder* examines some basic questions about how the state has used bonds to finance public works, how much bonds cost, and the impact of bonds on the budget.

How Big a Role Do Bonds Play in State Public Works Spending?

Conventional wisdom holds that state spending on public works has dropped significantly in recent years. Although most of the state's public works projects were built in the 1950s through the 1970s, state spending on public works has actually increased over the past 20 years. The 2005-06 budget agreement included nearly $1.7 billion in public works expenditures (excluding highways and transit), with approximately 88 percent of this spending coming from general obligation and lease-revenue bonds. The budget appropriated an additional $3.5 billion for transportation projects.[1]

Why Does the State Use Bonds to Pay for Public Works?

Bonds are long-term loans. The state raises money from investors that it pays back, with interest. Bonds provide financing for projects such as highways, University of California and California State University campuses, schools, and water projects that it cannot afford, or does not want to pay for, on a "pay-as-you-go" basis. Long-term borrowing allows the state to spread the cost of long-lived facilities over time and share the cost of paying for facilities among the individuals who benefit from these investments over a number of years or generations. The use of bonds to finance major investments in public facilities is similar to a family who uses a mortgage to purchase a home.

What Types of Bonds Does the State Issue?

The state has traditionally issued three types of bonds to finance public works:

- **General Obligation (GO) Bonds.** The state uses GO bonds to finance a variety of public works projects (Table 1). The state Constitution requires GO bonds to be approved by a two-thirds vote of the legislature and a majority of the voters. GO bonds are backed by the state's General Fund. The 2005-06 Budget appropriated $3.2 billion out of the state's General Fund for debt service on GO bonds (3.5 percent of total General Fund spending) and appropriated $11.8 billion in GO bond proceeds for various capital projects.[2]

- **Lease-Revenue Bonds.** Lease-revenue bonds, also called lease-payment bonds, were authorized by the legislature for the first time in 1983-84. Lease-revenue bonds require

Table 1: General Obligation Bond Ballot Proposals, 1972 to Present (Dollars in Millions)

	Proposed	Approved by Voters	Share Approved
Public Safety (Prisons/Jails)	$5,462	$4,087	75%
Seismic Retrofit	$4,800	$2,800	58%
K-12 Education	$39,575	$38,025	96%
Higher Education	$11,435	$9,935	87%
Environmental Quality/ Resources	$19,525	$15,086	77%
Transportation	$15,940	$2,990	19%
Housing	$3,560	$2,750	77%
Other*	$12,556	$10,741	86%
Total	**$112,853**	**$86,414**	**77%**

*Other includes veterans' home loans, health facilities, senior centers, libraries, and more.

Source: CBP analysis of Department of Finance data a majority vote of the legislature but do not require voter approval. The state typically uses lease-revenue bonds to finance the construction and renovation of state facilities, such as the recent expansion of the Franchise Tax Board and the new State Library building. State agencies and departments make annual lease payments to bond holders, funded primarily through General Fund appropriations. Unlike GO bonds, lease-revenue bonds are not backed by the full faith and credit of the state. As a result, lease-revenue bonds carry higher interest costs than GO bonds. The 2005-06 Budget included $622.3 million for the General Fund's debt service obligations on lease-revenue bonds (0.7 percent of total General Fund spending) and allocated $1.2 billion in lease-revenue bond proceeds for various projects.[3]

- **Revenue Bonds.** The state uses revenue bonds to finance revenue-producing projects such as toll bridges or parking structures. Revenue bonds are repaid with the revenues produced by the projects. Revenue bonds are authorized by the legislature and generally are not subject to voter approval.[4]

How Do Bonds Work?

GO bonds must be approved by the voters. Many GO bonds are put before the voters by the legislature using a bill that must be approved by a two-thirds vote and signed by the governor. GO bonds can also be placed on the ballot through the initiative process. Once authorized by the voters, the state treasurer sells bonds based on project needs and market conditions. When the state issues a bond it borrows money from investors and then repays this money, plus interest, over a period of years. The annual amount the state pays to investors (principal plus interest) is called debt service.

How Much Do Bonds Typically Cost?

Once bonds are sold, the state makes regular debt service payments to investors, usually over a 30-year period. Currently, each $1 billion of bonds sold costs the state approximately $65 million per year to repay the amount borrowed along with interest. At an interest rate of 5 percent, the state will pay $2 for each $1 it borrows over a 30-year period. After adjusting for inflation – since a dollar will be worth less in the future than it is today – each dollar borrowed will cost the state approximately $1.30, according to estimates by the Legislative Analyst's Office (LAO).[5]

How Much Does the State Currently Pay for Bonds?

According to the LAO, as of November 2005 the state had almost $53 billion of outstanding General Fund debt, including $42 billion in bond debt related to public works (roughly $35 billion in GO bonds and $8 billion in lease-revenue bonds). In addition, about $30 billion in bonds have been authorized, but not yet issued, for projects that are in progress or not yet begun. The LAO estimates that General Fund debt payments for GO and lease-revenue bonds for public works purposes will total about $3.9 billion in 2005-06 and $4.3 billion in 2006-07.[6]

Erin Riches prepared this Budget Backgrounder with the assistance of Jean Ross. The California Budget Project (CBP) was founded in 1994 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. General operating support for the CBP is provided by foundation grants, individual donations, and subscriptions. Please visit the CBP's website at www.cbp.org.

ENDNOTES

1 Legislative Analyst's Office, *A Primer: The State's Infrastructure and the Use of Bonds* (January 2006), p. 3 and *California Spending Plan 2005-06: The Budget Act and Related Legislation* (September 2005), pp. 49 and 58.

2 California Constitution, Article XVI, Section 1; Legislative Analyst's Office, *A Primer on State Bonds* (January 30, 1998); Department of Finance, *Chart K-1: General Fund: G.O. Bond Interest and Redemption Costs* (January 2006), downloaded from http://www.dof.ca.gov/Budget/BudgetFAQs.asp#10 on February 15, 2006; and *Governor's Budget Summary 2006-07* (January 2006), Schedule 9.

3 Legislative Analyst's Office, *Status: Uses and Costs of Lease-Payment Bonds* (May 3, 1995); Legislative Analyst's Office, *A Primer on State Bonds* (January 30, 1998); Legislative Analyst's Office, *A Primer: The State's Infrastructure and the Use of Bonds* (January 2006); Department of Finance, *Chart K-2: General Fund: Lease-Revenue Bond Interest and Redemption Costs* (January 2006), downloaded from http://www.dof.ca.gov/Budget/BudgetFAQs.asp#10 on February 15, 2006; and Department of Finance.

4 Legislative Analyst's Office, *A Primer: The State's Infrastructure and the Use of Bonds* (January 2006).

5 Legislative Analyst's Office, *An Overview: Transportation Infrastructure Proposals and Their Financing, Presented to Assembly Transportation Committee* (January 30, 2006), p. 2 and *Infrastructure Overview: Presented to the Conference Committee on Infrastructure Bonds* (February 16, 2006), p. 11.

6 Legislative Analyst's Office, *A Primer: The State's Infrastructure and the Use of Bonds* (January 2006).